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The Effect of Company Characteristics on Earnings Management

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ABSTRACT

Earnings management constitutes the strategic orchestration by a managerial entity in the presentation of financial statements, aimed at inflating or deflating reported profits. The objective of this study is to scrutinize the impact of specific financial factors, namely liquidity, profitability, firm size, leverage, and managerial ownership, on the dynamics of earnings management. The research encompasses a population of 194 manufacturing companies listed on the Indonesia Stock Exchange during the period spanning from 2018 to 2020. From this population, a sample comprising 43 companies was diligently selected, employing the purposive sampling methodology. Subsequently, the data analysis technique applied to the sample set is multiple linear regression analysis. The findings of this empirical investigation shed light on the intricate relationship between the aforementioned financial factors and earnings management. Specifically, it is determined that liquidity and firm size do not exert a statistically significant influence on earnings management practices. In contrast, profitability, leverage, and managerial ownership are identified as factors that positively contribute to earnings management activities within this specific industrial and temporal context.

Keywords: Liquidity, Profitability, Firm Size, Leverage, Managerial Ownership, Earnings Management

INTRODUCTION

The progress of a company's performance can be assessed through the company's ability to maximize or achieve profits, because profit is one of the main indicators used to be measure performance and is also the responsibility of management. Profit is a general indicator for management and external parties to assess the performance of a company. This Earnings information can influence investors, creditors, and other partiesin making investment and economic decisions. Therefore, the company tries to achieve the desired profit target so that the company looks like it has good performance and canattract the interest of external parties. Profit can also be used to measure the performance of the company's management within a certain period and to account for the managed resources that have been entrusted to the management/manager. However, managers often manipulate data for personal gain. This action is commonly known as Earnings management (Aorora, 2018; Wicaksono et al., 2018).

Earnings management, in the context of corporate governance, refers to the deliberate actions taken by company managers to influence the information presented in financial statements with the intention of misleading stakeholders seeking an accurate assessment of the company's financial health. It involves managerial interventions in the financial statement preparation process, resulting in the manipulation of reported profits without a corresponding change in the company's long-term economic viability. Due to the critical role of financial statements, management is often inclined to engage in activities aimed at enhancing the appearance of these statements. This may involve actions that alter the income statement to serve management's interests, including retaining their positions or securing higher bonuses. (Utama, 2017).

Motivated by variations in findings from prior research, the authors embarked on a re-evaluation of the influence of liquidity, profitability, firm size, leverage, and managerial ownership on earnings management. This investigation was conducted within the scope of companies listed on the Indonesia Stock Exchange (ISE) over the period of 2018-2020.

The rationale behind selecting manufacturing companies as the focal point of this research stems from their unique characteristics. Manufacturing companies listed on the ISE encompass a wide array of industrial sub-sectors, rendering them representative of the broader capital market's reactions. Furthermore, manufacturing companies dominate the market, a factor that justifies their selection as the primary subjects of this study. It is worth noting that manufacturing companies play a critical role in the production of raw materials that are subsequently transformed into finished goods.

LITERATURE REVIEW

Positive Accounting Theory

Positive Accounting Theory (PAT) is intended to explain and predict the consequences when managers make certain decisions. PAT assumes that companies will organize efficiently and organizer manner to maximize prospects for survival. PAT is closely related to the practice of Earnings management, because this theory is a theory that explains the practice of Earnings management in companies. PAT was put forwatd by (Ross L. Watts & Jerold L. Zimmerman, 1986; Cartwright, 2010) to describe and explain how the accounting process from the beginning to the present and how accounting information is presented so that it can be communicated to other parties within the company.

Accrording toWatts & Zimmerman (1986), in PAT, there are 3 hypotheses that can be a source of reference in explaining and predicting Earnings management symptoms or events in accounting, namely the bonus plan hypothesis, debtcovenant hypothesis and political cost hypothesis.

Earnings Management
Earnings Management (EM) may be defined as a purposeful manipulation of the profit recording process, often motivated by personal objectives. EM instances have been observed to yield adverse economic, ethical, and moral consequences, contributing to ongoing discrepancies in the comprehension and evaluation of managerial accounting practices. The lingering controversy primarily revolves around the classification of EM as fraudulent or a routine managerial practice.

This discrepancy in viewpoints is apparent between practitioners and academics, who grapple with the fundamental question of whether EM should be categorized as fraudulent. On one side, there is the perspective that EM constitutes a form of fraud executed by managers to deceive stakeholders. On the other, it is contended that EM represents a customary practice within managerial circles when compiling financial statements. The divergence in these interpretations has driven the advancement of empirical models aimed at delineating the nature of managerial activities. (Utama, 2017).

The Effect of Liquidity on Earnings Management
Liquidity (LQ) is the ability of a person or company to pay off debts that must be paid immediately using current assets. The liquidity ratio is usually measured by the ratio of current assets divided by current liabilities. The higher the ratio, the higher the liquidity position. The results of research conducted by (Saptantinah & Astuti, 2007) stated that liquidity has a positive effect on Earnings management.
H^1: Liquidity has a positive effect on Earnings management

The Effect of Profitability on Earnings Management
Profitability (PRT) is a ratio that shows the level of the company's ability to generate profits. The higher the profitability of a company, the effectiveness of management, performance and the company's ability to generate profits also increase. The results of research conducted by (Purnama, 2017) state that profitability has a positive effect on earnings management.
H^2: Profitability has a positive effect on Earnings management

The Effect of Firm Size on Earnings Management
The Firm Size (FS) of the company can affect earnings management, because the greater the ownership assets and the size of the company, the higher the occurrence ofearnings management practices. Rachmawati (2015) states that company size has a positive effect on earnings management which causes the company to bear large political costs, this situation refers to the political cost hypothesis. Large companies havethe motivation to carry out earnings management by lowering profits in order to reduce political costs.
H^3: Firm Size has a positive effect on Earnings management

The Effect of Leverage on Earnings Management
Companies that have a high Leverage (LG) ratio due to the large amount of debt compared to assets owned by the company are suspected of carrying out earnings management because the company is threatened with default, thus providing a relativelybetter bargaining position in negotiating or rescheduling the company's debt. Astuti (2017) shows that leverage has a positive effect on earnings management. Companies with higher debt are considered to have poor earnings quality.
H^4: Leverage has a positive effect on Earnings management

The Effect of Managerial Ownership on Earnings Management

Managerial Ownership (MO) is the percentage of shares owned by directors and commissioners of the company. The greater the managerial ownership in the company,the lower the tendency of managers to carry out earnings management activities because of the alignment of manager goals with shareholder goals. Yendrawati (2015) states that managerial ownership has a negative effect on earnings management, because management will be motivated to prepare quality financial reports.

H^5: Managerial Ownership has a positive effect on Earnings management

RESEARCH METHOD

This research was conducted on manufacturing companies listed on the Indonesia Stock Exchange in 2018 – 2020, the data is accessed through www.idx.co.id. The object in this study is the annual financial statements of manufacturing companies listed on the Indonesia Stock Exchange in 2018 - 2020 as many as 194 companies related to the influence of liquidity, profitability, firm size, leverage, and managerial ownership on earnings management. The method of determining the sample in this study was carriedout using a purposive sampling approach, with several predetermined criteria. The data collection method in this research is a documentation study.

The data analysis technique in this study tested descriptive statistical analysis to providean overview of the data and then tested it with the classical assumption test consisting of the Normality Test, Multicollinearity Test, Autocorrelation Test and Heteroscedasticity Test (Ulum et al., 2008; Sugiyono, 2017;). Hypothesis testing using multiple linear regression analysis with the following regression equation:

$$DA = \alpha + \beta_1 LQ + \beta_2 PRT + \beta_3 FS + \beta_4 LG + \beta_5 MO + \text{e}$$

Earnings management measurement uses Discretionary Accrual (DA). Liquidity used inthis study is the Current Ratio, to measure the company's ability to pay short-term obligations, which is measured based on the comparison between current assets and current liabilities. Profitability is proxied by Return on Assets (ROA). The higher the ROAvalue, the better the company's performance. Company size is a variable that is proxiedby the total assets of the company. Leverage describes the relationship between the company's debt to capital and assets using the Debt to Equity Ratio (DER) proxy. Managerial ownership can be measured by the number of shares owned by managers or directors of the board of commissioners to the total outstanding shares.

RESULTS

Table 1. Descriptive Statistics Example (*N* =129)

Construct	Min.	Max.	*M*	*SD*
LQ	.60	208.44	3.9447	18.29514
PRT	-.44	.26	.0321	.08409
FS	.10	352.00	13.8318	54.55816
LG	.03	5.37	.9434	.78752
MO	.0000128	.7007215	.110245292	.1709233649
EM	-.05	59.70	1.6894	8.65741

Note. M = Mean, SD = Standard Deviation.

Based on Table 1 it is known that the number of observations in the study (N) is 129. The results of the descriptive statistical test explain that the Liquidity variable (LQ) has aminimum data of 0.60 and a maximum value of 208.44 with an average of 3.9447 and a standard deviation of 18.29514 . Profitability variable (PRT) has a minimum data of -0.44 and a maximum value of 0.26 with an average of 0.0321 and a standard deviation of 0.08409. The variable Firm Size (FS) has a minimum data value of 0.10 and a maximumvalue of 352.00 with an average of 13.8318 and a standard deviation of 54.55816. The Leverage Variable (LG) has a minimum data value of 0.03 and a maximum value of 5.37with an average of 0.9434 and a standard deviation of 0.78752. Managerial Ownership Variable (MO) has a minimum data of 0.0000128 and a maximum value of 0.7007215 with an average of 0.110245292 and a standard deviation of 0.1709233649. Eranings Management (EM) variable has a minimum data of -0.05 and a maximum value of 59.70with an average of 1.6894 and a standard deviation of 8.65741.

Table 2. Results of Multiple Linear Regression Analysis

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-.046	.075		-.608	.544
LK	.006	.004	.012	1.557	.122
PRT	.647	.009	.676	73.873	.000
UP	-.002	.001	-.014	-1.770	.079
LG	.585	.009	.539	67.293	.000
KM	-1.307	.044	-.270	-29.512	.000
a. Dependent Variable: DA					

Based on Table 2, a Multiple Linear Regression equation can be obtained as follows:

$$DA = -0{,}046 + 0{,}006LK + 0{,}647PRT - 0{,}002UP + 0{,}585LG - 1{,}307KM + \text{e}$$

DISCUSSION

The first hypothesis (H^1) states that liquidity has no effect on earnings management. Based on the results of hypothesis testing, it shows that liquidity has no effect on earnings management. This can be seen from the significance level of 0.122 which is greater than (0.05) so that H^1 is rejected. This is due to a high level of liquidity, the company will be better able to pay off its short-term obligations to creditors, so it tends not to carry out earnings management. According to Dahana (2013) creditors do not onlysee the high or low liquidity of the company, as long as the profits are stable the creditorsare not concerned about the company's liquidity. The results of this study are consistentwith research conducted by Winingsih (2017) which shows that liquidity has a significantnegative effect on earnings management.

The second hypothesis (H^2) states that profitability has a positive effect on earnings management. Based on the results of hypothesis testing, it shows that profitability has a positive effect on earnings management. This can be seen from the significance level of 0.000 which is less than 0.05 so that H^2 is accepted. Profitability has a positive effect on earnings management because management knows the company's ability to earn profitsin the future so that it can facilitate delaying or accelerating the recognition of expenses or income in certain periods. The results of this study are consistent with the bonus plan hypothesis when a company earns high profits far above the target for obtaining a bonus, managers will adjust earnings so that reported profits are not too large so that excess profits in that period will be presented in the following period, so that the profits obtainedby the company will look stable. Large profits will attract investors because the companyhas a higher rate of return. The results of this study are consistent with research conducted by Winingsih (2017), Astuti (2017), Purnama (2017) and Gunawan (2015) byshowing the results that profitability has a significant positive effect on earnings management.

The third hypothesis (H^3) in this study is that company size has no effect on earnings management. Based on the results of hypothesis testing, it shows that company size hasno effect on earnings management. This can be seen from the significance level of 0.079,which means that the significance value of 0.079 is greater than 0.05 so H^3 is rejected. The existence of strict supervision from the government, analysts, and investors who participate in running the company cause managers not to dare to do income smoothingwhich is a form of earnings management action. If a manager is known to practice earnings management, it can damage the credibility and image of the company'smanager. This shows that company size does not necessarily reduce the possibility of earnings management. The results of this study contradict the research conducted by Astuti (2017) which states that company size has a positive and significant effect on earnings management. The results of previous research that are in accordance with thisresearch are research conducted by Pagalung (2017) and Sosiawan (2012).

The fourth hypothesis (H^4) in this study is that leverage has a positive effect on earnings management. Based on the results of hypothesis testing, it shows that leverage has a positive effect on earnings management. This can be seen from the significance level of 0.000 which is less than 0.05 so that H^4 is accepted. Companies with high leverage levelswill no longer use loans as a source of funds and will switch to equity funding. Therefore,the company must have good performance and high profits to attract potential investors.This research is in accordance with the debt convenant hypothesis, namely managers are motivated to take earnings management actions to avoid violating debt agreements.High leverage is caused by management errors in managing the company's finances orthe implementation of an inappropriate strategy on the part of management. This showsthat leverage has a positive effect on earnings management. The results of this study are in accordance with research from Agustia (2013) showing the results that leverage has a significant positive effect on earnings management.

The fifth hypothesis (H^5) in this study is that managerial ownership has a positive effect on earnings management. Based on the results of hypothesis testing, it shows that managerial ownership has a positive effect on earnings management. This can be seen from the significance level of 0.000 which is smaller than 0.05 so that H^5 is accepted. This is because a manager who also has shares has a personal interest, namely the return obtained from his share ownership in the company. This is due to information asymmetry, namely a condition where one party has excess information compared to theother party. The higher the managerial share ownership, the higher the possibility of earnings management. The results of this study do not support previous research, namely Yendrawati (2015) who found managerial ownership had a significant negative effect on earnings management.

CONCLUSION

This research was conducted with the aim of knowing the effect of Liquidity, Profitability,Firm Size, Leverage and Managerial Ownership on Earnings Management in manufacturing companies listed on the Indonesia Stock Exchange in 2018-2020. The test results conclude that Liquidity and Firm Size have no effect on the Earnings Management of manufacturing companies listed on the Indonesia Stock Exchange in 2018-2020. While Profitability, Leverage and Managerial Ownership have a positive effect on Earnings Management in manufacturing companies listed on the Indonesia Stock Exchange in 2018-2020. The test results reveal that, within the context of manufacturing companies listed on the Indonesia Stock Exchange during the 2018-2020 period, Liquidity and Firm Size do not exert a significant influence on Earnings Management. In contrast, the variables of Profitability, Leverage, and Managerial Ownership exhibit a notable positive impact on Earnings Management in these manufacturing companies.

This suggests that while Liquidity and Firm Size do not play a substantial role in shaping Earnings Management practices, Profitability, Leverage, and Managerial Ownership are influential factors contributing to a propensity for Earnings Management activities within this specific industry and timeframe.

LIMITATION

The limitations and suggestions in this study are that this research only takes a period of three years (2018-2020). This study does not divide data based on the type of industry of each company studied. Future studies are expected to use a longer observation periodso as to provide a larger sample size, and are further expected to develop this research by expanding the independent variables that can detect Earnings Management incompanies such as Audit Quality, Bonus Compensation, and Information Asymmetry.

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DECLARATION OF CONFLICTING INTERESTS

The author states truthfully and is aware that we do not have a conflict of interest in the writing or research of this manuscript.

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