

The Effects of External Audit, Independent Commissioner, and Firm Size on Earnings Management

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ABSTRACT

This research aimed to examine the effects of external audit variables, independent commissioners, and firm size on earnings quality among manufacturing companies during the period of 2017-2019. Discretionary accruals are taken as a proxy for earnings quality, because those are components of accruals that can be regulated and engineered according to managerial policies so that they can have a direct impact on earnings quality. The sample of this study amounted to 181 data. Data was obtained using the *Statistical Package for Social Sciences (SPSS)* software for *Windows* version 22.0. As the results of this research, External Audit has a significant effect on earnings quality, Independent Commissioners has no significant effect on earnings quality, and Firm Size has no significant effect on earnings quality as well.

Keywords: *External Audit, Independent Commissioner, Firm Size, Earnings Management*

1. INTRODUCTION

The annual financial report is a mandatory report with the information contained in the financial statement, which is a statement of financial position, comprehensive income statement, statement of changes in equity, and cash flow statement accompanied by an explanation of the financial statements. Financial statements are the records of a company's financial information that can be used to describe how the company's condition is. Mandatory financial statements must be audited by a Public Accounting Firm. As an investor, financial statements are an investor's weapon to assess whether the company is worth investing in or not. Financial report is a tool to convey financial information as a form of management accountability [1]. The submission of information through financial reports is expected to help external parties to assess the company's performance. One of the important components in financial statements is profit. According to [2] "...investors are becoming more interested in the quality of firm's earnings".

Income Statement presents the profit or loss for the current period, which is an indicator used to measure the company's performance during the particular period. Profit is one of the important information used by external parties, especially investors and creditors.

The profit reported in the financial statements is generated by using the accrual method. By using the accrual basis, an entity's financial statements are recorded in the period in which it occurs, not in the period when the entity issues or receives cash [3]. The implementation of Generally Accepted Accounting Principles (PABU) causes management to choose accounting policies from various

existing policy options that allow earnings management within the company [4]. Earnings management will indicate low earnings quality, because those are not presented in accordance with the actual audit [5].

The phenomenon of financial scandals involving financial statement issues, has often occurred in public companies. One example of this, is the profit manipulation carried out by Enron and PT. Garuda Indonesia. The Enron case can be a lesson for investors, potential investors, management, and accountants to practice business with integrity, honesty, trust, and responsibility to stakeholders. This scandal dragged auditor Arthur Andersen, so it had to be dissolved, whereas Arthur Andersen was one of the big-five auditing-firms in the world at that time. Moreover, the one who manipulated the financial statements was a company that could be considered a large and well-known company. Surely many are wondering what the manipulation of financial statements aims. Of course, this manipulation of financial statements aims to generate the profits, but in a dishonest way. It's just that sometimes companies do things that are not normal, as happened recently at PT. Garuda Indonesia, which manipulated its financial statements. As reported from [6] website, Friday (28/6/2019), the beginning of financial statements manipulation began on April 24, 2019. The 2018 financial year posted a profit net of USD 809.85 thousand or equivalent to Rp. 11.33 bio, as compared to a loss of USD 216.5 million in 2017.

However, the report caused a polemic, because two Garuda Indonesia commissioners, considered that Garuda Indonesia's 2018 financial statements to be inconsistent with the Statement of Financial Accounting Standards (PSAK). As a result, the two commissioners were also

reluctant to sign Garuda Indonesia's 2018 financial statements.

So how did the Financial Services Authority (OJK) respond to this case? As reported from [7] page, Financial Services Authority Press Release, the Case of PT. Garuda Indonesia (Persero) Tbk. SP 26/DHMS/OJK/VI/2019 Thursday (28/06/2019), the Financial Services Authority (OJK) 'hands off' to the financial statements of PT. Garuda Indonesia (Persero) Tbk. between a number of commissioners and management. The regulator submitted the case to the Indonesia Stock Exchange (IDX) and asked it to verify the accuracy of Garuda Indonesia's 2018 financial report book. The chairman of the OJK Board of Commissioners, Wimboh Santoso, stated that his party did not have direct authority to examine the issue of Garuda Indonesia in depth. It is different if this problem afflicts banks, insurance, and financial companies.

The act of earnings manipulation will ultimately impact on the quality of earnings itself. The conflict that occurs due to the separation of ownership is called the agency conflict. Earnings quality can be seen from the benefits for business decision-making among the users of financial statements. Quality earnings are earnings that can reflect the continuation of future earnings [8].

In supporting the creation of good supervision, it is necessary to implement Good Corporate Governance (GCG). The implementation of GCG is needed to control the behavior of managers so that they act not only to benefit themselves, but also to equalize the interests of company owners and managers.

The research has been conducted about the effect of GCG on earnings quality. One of them is the research conducted by [9], concluding that there is a significant and negative influence of corporate governance as proxied by board size and audit committee size on earnings quality, while external auditors do not necessarily reduce earnings management. This is different from the results found by [1], which revealed that audit committee had no significant impact on earnings quality, while the external audit had a positive effect on earnings quality.

Based on the background stated previously, it can be seen that the implementation of GCG is very influential on the earnings quality. Management can apply the accounting policies that benefit personally through the application of discretionary accruals.

Several previous studies examining the factors that affect earnings quality, have obtained mixed results. Therefore, researchers are encouraged to conduct some researches again on the effect of corporate governance and intellectual capital on earnings quality.

This research objective was to examine the effect of external audit variables, independent commissioners, and company size on earnings quality among manufacturing companies for the period 2017-2019.

2. LITERATURE REVIEW

2.1. Financial Statements

The financial statements' objectives are: "To provide information about the financial position, financial performance and cash flows of an entity that is useful to the majority of users of the report in making economic decisions" [10].

2.2. Earnings Quality

[2] mentioned that: "Earnings quality is defined as the degree of correlation between a company's accounting income and its economic income". Earnings quality is the ability of earnings to reflect net income, as well as the usefulness of earnings to predict future earnings [11].

[12] and [13] classified earnings quality and its measurement into four parts. Based on the time-series of earnings, earnings quality includes: persistence, predictability, and earnings variability. Based on the characteristics of FASB's Conceptual Framework, earnings quality has relevance, reliability, and comparability aspects.

Discretionary accruals (DA) are the accrual components that can be regulated and manipulated in accordance with the managerial policies, while non-discretionary accruals (NDA) are the accrual components that cannot be measured and manipulated in accordance with company management policies [14].

2.3. External Audit

[15] defined auditing as a process to validate the financial statements. The outside party in this case, is the Public Accounting Firm (KAP). KAP is a business entity that has obtained a permit from the Minister as a forum for Public Accountants in providing their services.

[16] argued that KAP, in this case is the big-four KAP, has higher quality in training and international recognition, so that it will increase the scale of trust in the accounting firm compared to non-big-four KAP. The quality of audit can also be higher so that the quality of earnings presented by the company also increases.

2.4. Independent Commissioners

Independent Commissioners that become the guidelines for GCG are those coming from outside the company. According to Article 120 paragraph (2) of Law no. 40 of 2007 concerning Limited Liability Companies (UU PT), "Independent commissioners are appointed based on the resolutions of the GMS from parties who are not affiliated with the main shareholders, members of the board of directors and/or other members of the board of commissioners". Board of Commissioners plays a very important role in the company, especially in the implementation of GCG.

2.5. Company Size (Firm Size)

Company size is a value that determines whether the size of a company is big or small. According to [17]: “Larger companies will usually have a bigger role as stakeholders. This will make the policies issued by large companies, will have a greater impact on the public than do small companies. With this, large companies will be noticed by the public so that they will be more careful in conducting financial reporting, so that the condition of the financial statements reported must be more accurate”.

2.6. Hypothesis Formulation

A hypothesis is a temporary answer to a problem that is still presumptive, because it still has to be proven true. The hypotheses in this research were described as follows:

H₁: External audit positively and significantly affects earnings quality.

An external audit is an audit conducted by an external (independent) agency that meets the requirements, which aims to determine whether the accounting records are accurate and complete, whether they are prepared in accordance with PSAK provisions, and whether the reports prepared from the data present a position financial and financial results of operations fairly.

H₂: Independent commissioner positively and significantly affects earnings quality.

Independent commissioner is a member of the Board of Commissioners, who is not an employee or person dealing

directly with the organization, and does not represent the shareholders.

H₃: Firm size positively and significantly affects earnings quality.

Firm size is the size of a company seen from the amount of equity value, sales value, or asset value.

3. METHOD

3.1. Data Collection Techniques

The data used in this research is in form of secondary data that has been collected by various people (organizations) for specific purposes and is available for various studies. The data in this research comes from the annual reports published in the 2017-2019 period. Data on the company's financial statements and annual reports were obtained from www.idx.co.id. [18].

3.2. Data Processing Techniques

Data was processed initially using the *SPSS for Windows* version 22.0. Furthermore, from the processed data, the descriptive statistical analysis, normality tests, and classical assumption tests were carried-out to test the feasibility of using the regression model before conducting the hypotheses tests.

4. ANALYSIS AND DISCUSSION

4.1. Descriptive Statistics

Table 1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DACC	181	-0.13805	0.19832	0.0372414	0.06287499
ExAUD	181	0	1	0.44	0.498
INCOM	181	0.16667	1.00000	0.3883694	0.12089262
FSIZE	181	25.27668	33.09498	28.2075100	1.71013777
Valid N (listwise)	181				

Source: *SPSS for Windows* version 22.0

4.2. Normality Test

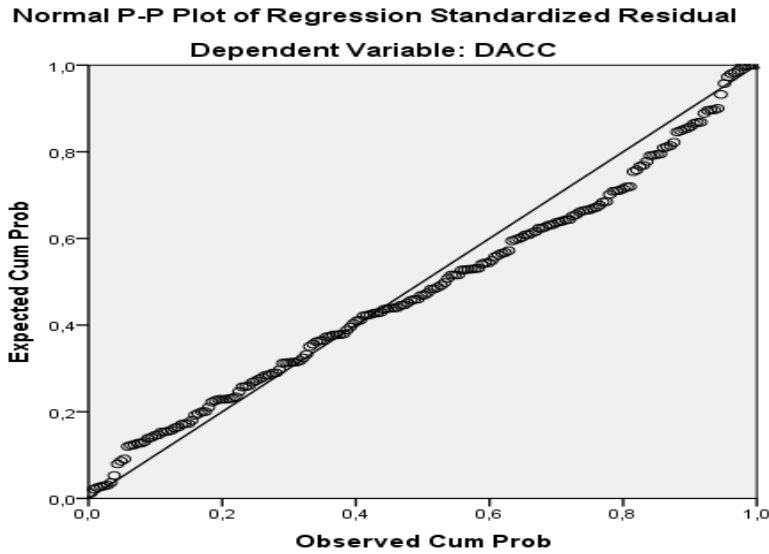


Figure 1 Normality Probability Plot

In Figure 1, the patterns of dots do not follow and approach the diagonal line. Thus, it can be concluded that the data in this research was not normally distributed. If you only look at the graph above, it may be misleading,

therefore the researchers also conducted statistical test analysis using the One-Sample Kolmogorov-Smirnov test, of which the results are presented in Table 2.

Table 2 One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		198
Normal Parameters ^{a,b}	Mean	0.0000000
	Std. Deviation	0.07884313
Most Extreme Differences	Absolute	0.089
	Positive	0.089
	Negative	-0.059
Test Statistic		0.089
Asymp. Sig. (2-tailed)		0.001 ^c

Test distribution is Normal.

Source: SPSS for Windows version 22.0

4.3. Heteroscedasticity Test

Table 3 Heteroscedasticity Test

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.091	0.061		1.485	0.139
	ExAUD	0.008	0.008	0.113	1.101	0.273
	INCOM	-0.040	0.024	-0.129	-1.647	0.105
	FSize	-0.003	0.002	-0.143	-1.373	0.1711

Source: SPSS for Windows version 22.0.

The significance value of the External Audit variable (ExAUD) is 0.273, Independent Commissioner (INCOM) is 0.105, and Firm Size (FSIZE) is 0.1711. The significance value of the 8 variables shows a value greater than 0.05. Therefore, it can be concluded that there is no heteroscedasticity problem in this research regression model.

4.4. Multicollinearity Test

The multicollinearity test aims to test whether there is a correlation among the variables of independent commissioner, external audit, and firm size.

Table 4 Multicollinearity Test

Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	ExAUD	.521	1.915
	INCOM	.895	1.115
	FSIZE	.503	1.977

a. Dependent Variable: DACC
Source: SPSS for Windows version 22.0.

The tolerance value of External Audit (ExAUD) is 0.521, Independent Commissioner (INCOM) is 0.895, and Firm Size (FSIZE) is 0.503. The VIF value of External Audit variable (EXAUD) is 1.915, Independent Commissioner (INCOM) is 1.115, and Firm Size (FSIZE) is 1.977.

4.5. Autocorrelation Test

Table 5 Autocorrelation Test

Model	R	R Square	Adjusted R Square	Std. Error of Estimate	Durbin-Watson
1	.367 ^a	.135	.094	.05983071	2.066

a. Predictors: (Constant), FSIZE, COM, EXAUD, HCE
b. Dependent Variable: DACC
Source: SPSS for Windows version 22.0.

The DW statistics shows a value of 2.066. This value is then compared with the values of dL (lower limit) and dU (upper limit) from the Durbin-Watson Table. The value from the Durbin-Watson Table with the number of samples (n) of 181 and the independent variable (k) of 3, generates the value of dL = 1.6667 and dU = 1.8498, so that the 4-dU value is 2.1502.

4.6. Hypothesis Testing

Basically, the multiple linear regression equation in this research is as follow:

$$DACC = a + b_1 \text{ ExAUD} + b_2 \text{ INCOM} + b_3 \text{ FSIZE} + e$$

4.6.1. Correlation-Coefficient Test (R-Test)

Table 6 Correlation-Coefficient Test

Model	R	R Square	Adjusted R Square	Std. Error of Estimate	Durbin-Watson
1	.368	.135	.094	.05983071	2.066

a. Predictors: (Constant), FSIZE, ExAUD, INCOM, HCE
b. Dependent Variable: DACC
Source: SPSS for Windows version 22.0.

The correlation coefficient value shows the number 0.368. The relationships among the variables of External Audit, Independent Commissioner, and Firm Size, with earnings quality is weak, because the value is between 0.20 and 0.399. The direction of the relationships between these variables is positive, meaning that if the variables of External Audit, Independent Commissioner, and Firm Size increase, then the Earning Quality variable also increases.

4.6.2. Adjusted R-Square Test

Table 7 Adjusted R-Square Test

Model	R	R Square	Adjusted R Square	Std. Error of Estimate	Durbin-Watson
1	.368	.135	.094	.05983071	2.066

a. Predictors: (Constant), FSIZE, COM, EXAUD, HCE
b. Dependent Variable: DACC
Source: SPSS for Windows version 22.0.

In this research, the Adjusted R-square value is 0.093. The influence of External Audit, Independent Commissioner, and Firm Size on Earnings Quality is 9.3%, while the remaining 90.7% of variation in the Earnings Quality variable is influenced or explained by other factors not in the scope of this research.

4.6.3. F-Test (ANOVA)

The F-test was conducted to determine the simultaneous effect of the independent variables, namely External Audit, Independent Commissioner, and Firm Size, on the dependent variable, namely Earnings Quality.

Ho: There is no significant effect of External Audit, Independent Commissioner, and Firm Size on Earnings Quality simultaneously.

Ha: There is a significant effect of External Audit, Independent Commissioner, and Firm Size on Earnings Quality simultaneously.

Table 8 F-Test

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.096	8	.012	3.361	.003 ^b
	Residual	.619	173	.004		
	Total	.716	181			

a. Dependent Variable: DACC
b. Predictors: (Constant), FSIZE, COM, EXAUD
Source: SPSS for Windows version 22.0.

The resulting significance value is 0.003, which is smaller than 0.05. So, it can be concluded that there is a significant influence of external audit, independent commissioner, and firm size on earnings quality simultaneously. Therefore, it can be concluded that these three independent variables simultaneously have a significant influence on earnings quality among the manufacturing companies listed in IDX for the 2017-2019 period.

4.6.4. t-Test

The t-statistical tests were performed to determine whether the External Audit, Independent Commissioner, and Firm

Size variables individually has an effect on Earnings Quality.

Ho: Each of the External Audit, Independent Commissioner, and Firm Size variables, has no effect on Earnings Quality.

Ha: Each of the External Audit, Independent Commissioner, and Firm Size variables, has a significant effect on Earnings Quality.

Table 9 t-Statistics Test

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	
	B	Std. Error	Beta			
1	(Constant)	-.029	.099		-.305	.761
	ExAUD	-.029	.012	-.211	-2.156	.031
	INCOM	-.037	.039	-.071	-.944	.345
	FSIZE	.003	.004	.120	1.205	.210

a. Dependent Variable: DACC

Source: SPSS for Windows version 22.0.

In this research, the multiple linear regression equation was developed as follow:

$$DACC = - 0.029 - 0.029 ExAUD - 0.037 INCOM + 0.003 FSIZE$$

Description:

DACC = Discretionary Accruals as a proxy for Earnings Quality

ExAUD = External Audit

INCOM = Independent Commissioner

FSIZE = Company size (Firm Size)

Based on the regression equation above, it can be seen that the value of the constant coefficient is -0.029. This shows that if the external audit, independent commissioner, and firm size are equal to zero, then the discretionary accrual value is -0.029 units.

The coefficient value of β_1 is -0.029. If the external audit value increases one unit, then the discretionary accrual value will decrease by -0.029 units, under the assumption that the independent commissioner value and firm size variables are constant.

The coefficient value of β_2 is -0.037. This shows that if the value of the independent commissioner increases by one unit, then the value of discretionary accruals will decrease by -0.037 units, under assumption that the external audit value and firm size variables are constant.

The coefficient value of β_3 is 0.003. This shows that if the firm size value increases by one unit, then the discretionary accrual value will increase by 0.003 units, under the assumption that the value of external audit and independent commissioner variables are constant.

The first hypothesis (H_1) mentioned that external audit has significant effect on earnings quality. The result in Table 9 shows that the significance value of external audit variable is 0.031. This value is smaller than 0.05, thus H_1 was accepted, which means that external audit has a significant effect on earnings quality.

The second hypothesis (H_2) proposed in this research mentioned that independent commissioners have a significant effect on earnings quality. The result in Table 9 above shows that the significance value of independent commissioner variable is 0.345, whereas the value is higher than the significance level of 0.05. Therefore, the second hypothesis (H_2) was rejected, which means that the independent commissioner has no significant effect on earnings quality.

The third hypothesis (H_3) in this research mentioned that firm size has a significant effect on earnings quality. The result in Table 9 above shows that the significance value of firm size variable is 0.210, whereas the value is greater than the significance level of 0.05. Hence, the third hypothesis (H_3) was rejected, meaning that firm size does not have a significant effect on earnings quality.

4.7. Discussion

The results of this research only support one of the three hypotheses formulated. However, it does not support the research from [9] and [16], who found that external audit had no significant effect on earnings quality. On the other hand, the similar research from [19] was conducted among 508 companies listed in the Malaysia Stock Exchange for the 2009-2011 period. The result is in line with the

research from [1], which also found that the external audit committee has a significant and negative influence on discretionary accruals.

The agency theory assumes that the agent has more information than does the principal, which can cause the information asymmetry, and then a third-party is needed, in this case, an external auditor, who is able to re-examine the company's financial statements. The big-four KAPs have higher quality in terms of training and international recognition so that they will be more trusted by the public (community) because of such reputation. With a better reputation from the public point of view, the big-four KAPs will continue to try to maintain this achievement so that they will still gain the public trust. In order to maintain this reputation, the big-four KAPs are required to work more competently, more carefully in detecting fraud, and be more independent than non-big-four KAPs.

With the high quality offered by the big-four KAPs, they will be better in detecting and minimizing the earnings management actions. In this regard, using the services of the big four KAPs will result in a better-quality audited financial information, whereas the profits presented in the financial statements can reflect the actual phenomenon. The profit presented in accordance with the actual conditions is a quality profit.

The second hypothesis (H_2) mentions that independent commissioners have no significant effect on earnings quality with significance value of 0.345, which is greater than 0.05. Therefore, H_2 was rejected, meaning that the independent commissioner has no significant impact on earnings quality.

This result does not support the hypothesis formulated and also does not support the research conducted by [1] among 22 manufacturing companies listed in the Indonesia Stock Exchange (IDX) for the period of 2007-2011, which found that the Board of Commissioners has a significant influence on earnings quality. On the other hand, the result of this study supports the research conducted by [16] among 33 property companies listed in the IDX for during 2010-2017 as well as the research conducted by [20] among 24 banks listed in the IDX during the 2010-2017 period. Their researches show that independent commissioners have no significant impact on the quality of earnings.

The third hypothesis (H_3) mentions that firm size has no significant effect on earnings quality. The significance value of firm size is 0.210, which is greater than 0.05. Thus, H_3 was rejected. This means that firm size does not have a significant effect on earnings quality.

The result of this study does not support the formulated hypothesis and is different from the research conducted by [9]. This is because the possibility of using the natural logarithm of total assets formula as a reference to measure the size of the company, cannot explain the discretionary accruals. Market capitalization can be another alternative to measure the size of a company.

Most manufacturing companies are large companies, but investors prefer to look at the company's market conditions in general, rather than looking at their total assets. In addition, the size of a company cannot be a reference for

management to manipulate its earnings, but in general these actions are carried-out to show good earnings quality with the aim of attracting investors' attention so as to obtain a larger investment activity.

5. CONCLUSIONS AND SUGGESTIONS

5.1. Conclusions

The purpose of this study was to empirically prove the effects of external audit, independent commissioner, and firm size on the earnings quality among the manufacturing companies for the 2017-2019 period. Discretionary accruals were taken as a proxy for earnings quality, because these components of accruals can be regulated and engineered according to the managerial policies so that they may have a direct impact on the quality of earnings.

The result of F-statistical test (ANOVA) in this research indicates that there is a significant influence of external auditor, independent commissioner, as well as the firm size, on the quality of earnings simultaneously. As the results of the t-statistical test: (1) External audit has a significant effect on the quality of earnings; (2) Independent commissioners have no significant effect on earnings quality; and (3) Firm size does not have a significant effect on the quality of earnings.

5.2. Suggestions

The credibility of financial statements should be further enhanced by more effectively implementing the good corporate governance in Indonesia. It is intended that every user of financial statements does not make wrong decisions before investing in a company. Investors as the parties who provide sources of funds for companies must also be careful in interpreting the published financial statements.

This study has several limitations, namely: (1) The companies used as research samples are those from the manufacturing sector only; (2) The use of natural logarithm formula for total assets is not suitable in measuring the size of company; and (3) The variables used in this study only slightly explain their effects on earnings quality. This can be seen from the Adjusted R square value, whereas this value shows that only 9.4% of the independent variables can explain the earnings quality. Based on these limitations, suggestions for further research are: (1) Use another industrial sector as the research sample; (2) Use other alternatives, namely market capitalization as a proxy for company size; (3) Use other variables that are more representative in explaining earnings quality; and (4) Use intellectual capital as a moderating variable in the future research on earnings quality.

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