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THE INFLUENCE OF EARNINGS MANAGEMENT AND AUDIT QUALITY ON FERC WITH FINANCIAL PERFORMANCE AS MODERATION

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Abstract

The aim of this research is to examine the influence of earnings management, auditor quality on the Future Earning Response Coefficient, moderated by Financial Performance and Size and CAR as control variables. This research uses secondary data in the form of banking sector financial reports listed on the IDX in 2017-2022. The number of samples used in the research was 41 companies, so the total observations were 205 financial reports. Panel data analysis method using Eviews. The results of this research prove that 1) Earning Management has supported to have a positive and significant effect on FERC; 2) Audit quality is supported to have a positive effect on FER; 3) ROE is not proven to be a moderating variable in the FERC function so that the influence of EM and KA which are moderated by ROE on FERC is not supported.

Keywords: *Earning Management, Audit Quality, Financial Performance, FERC*

INTRODUCTION

The importance of a company's earnings is demonstrated by the fact that the value of a company's shares represents the value of its future earnings. Consequently, company managers use certain strategies to deliberately manipulate company revenues to conform to predetermined targets by involving the planning and implementation of certain activities that manipulate or smooth revenues, achieve high levels of income and influence the company's stock price.

These earnings management activities can occur because managers have flexibility in making accounting or operating choices, or because managers seek to convey private information to users of financial reports. Submission of personal information can be done to provide stakeholders with information, which is not otherwise available, so that they can adjust their expectations appropriately. Careful release of such information could impact a company's earnings and stock price. If the information conveys significant value relevance to analysts and other users of financial reports, they may also adjust earnings and stock price estimates for other companies in the industry. This can positively influence companies that disclose information to experience a positive impact on their share prices because they are considered to have higher earnings quality.

Audit quality is basically a complex and multi-perspective concept. DeAngelo (1981) defines audit quality as the market-assessed joint probability that a particular auditor will (a) discover violations in the client's accounting system and (b) report violations. This definition according to De Angelo (1981) is widely quoted by audit researchers. This definition highlights two important aspects of audit quality, namely: (1) the competency of the audit firm which determines how likely it is that misstatements will be detected and (2) the auditor's independence and objectivity which determines what the auditor is likely to do.

about detected misstatements. This definition is very useful for audit quality studies. The import of DeAngelo's (1981) definition is that audit quality is the probability that an auditor will discover and honestly report material errors, misrepresentations, or omissions in a client's financial statements.

Previous research shows that audit quality has a significant negative influence on information disclosure and FERC (Murwaningsari, 2014). Large public accounting firms (KAP) are more likely to provide high quality financial reports with more informative disclosures. So this can increase investors' ability to anticipate changes in future profits. This research is different from the research results of Tarmidi, Murwaningsari, and Ahnan, 2021, where this research did not find evidence that investors reacted to audit quality. This indicates that there are still many investors who do not trust the performance of financial report auditors in Indonesia, so large auditors are not used in considering investment transactions. This is suspected because many cases, both in Indonesia and around the world, involve big four auditors who are considered credible and capable in the financial report audit process.

In its hypothesis, this research uses signaling theory, referring to the strategy used by a company's internal management to inform investors about the company's condition or future prospects (Brigham & Ehrhardt, 2005). Companies with a promising future are less likely to sell their current shares and more likely to take alternative steps to promote the business, such as borrowing money, even when this is outside the constraints of the capital structure. In contrast, businesses with poor future prospects usually sell their shares and use special strategies to attract investors. The announcement of a company's stock sale usually serves as a warning indication that the business is not doing well. Any information presented has important meaning for investors regarding their funding or investment decisions regarding buying and selling shares on the stock exchange because signals are issued by company management through various information. In general, important information contains notes or descriptions of previous events, activities currently being carried out, or potential future events related to company policies in carrying out company operations.

This research will analyze the influence of Earnings Management and *Audit Quality* on FERC. This research also tests whether financial performance is able to moderate the influence of Earnings Management and *Audit Quality* on FERC. With control variables company size and company age.

LITERATURE REVIEW

Profit management

Based on information management earnings theory, managers will use their discretion to transmit their beliefs based on the information they have as insiders (personal information) about the company's future profit prospects. Two intentions underlie managers in managing earnings. First, if management reports profits according to investor expectations, then the company's performance will decline. Second, only companies with good prospects can maximize profits this year at the risk of taking some profits in the following year. Because, if the following year turns out to be lower, this action will be a loss (Tucker and Zarowin,

2006). Research related to the influence of earnings management on FERC by Sari and Febriyanto, 2019 proves that earnings management as proxied by income smoothing has an effect on FERC. Likewise, Rachmawati, 2021 also proves that income smoothing has a negative effect on FERC.

H1. Earnings management has a negative effect on FERC

Audit Quality

Audit quality is about processing information accurately, thoroughly, and without bias to produce reliable financial reports. Generally, audit quality is proxied by the size of the audit company. While this is not always the case, the "big four" auditors (Deloitte, KPMG, PwC, and Ernst & Young) are considered more qualified due to the size of the organizations in the audit world and their processes being constantly updated. and they use better methods. High audit quality has been proven to reduce the risk of stock declines (Khajavi & Zare, 2016), thereby influencing investment policies. Matoke & Omwega (2016) found that audit quality as proxied by the big four auditors received positive reactions from investors because they believed their processes were better and more orderly according to applicable standards.

H2. The quality of the company's financial report audit has a positive effect on FERC

Financial performance

Investors expect good returns in the form of dividends, which are distributed when the company has earned sufficient profits. Good management performance can be seen from the company's high profits and the company's financial performance indicators, so that these indicators are something that investors pay attention to. Financial performance with indicators has a positive impact on investor reactions. High financial performance as proxied by ROA, ROE, and NIM has an impact on investors' positive reactions in the form of share prices (Tarmidi et.al. 2021, Wulansari & Prihantoro, 2018).

H3: Financial performance can strengthen the influence of earnings management on FERC

H4: Financial Performance can strengthen the influence of Audit Quality on FERC

The author has created a research model as in Figure 1 below:

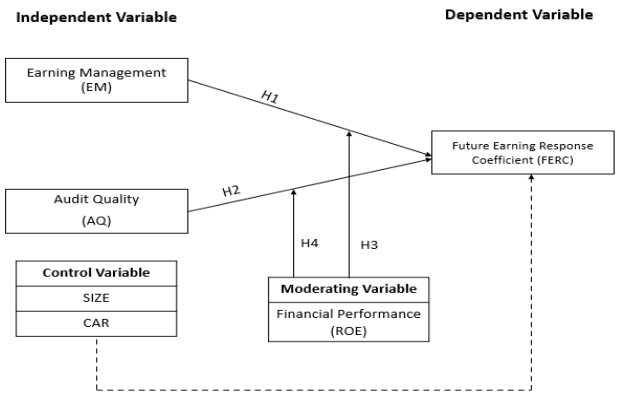

Figure 1. Research Model

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METHOD

The research design used is quantitative research using hypothesis testing, namely testing and analyzing the influence of independent variables on the dependent variable, namely testing the influence of earnings management, auditor quality on the Future Earning Response Coefficient, moderated by Financial Performance and Size and CAR as control variables, with a structure panel data, then a panel regression analysis tool is used.

The variables in this research consist of 1 dependent variable, 2 independent variables, 1 moderating variable and 2 control variables with an explanation of each variable as follows.

Dependent variable

The dependent variable used is *the Future Earning Response Coeffcient* (FERC) where the measurement is adopted from Murwaningsari (2014), and Rachmawati (2021) who states that the dependent variable FERC is the response coefficient of future earnings returns, which is expressed by the equation

$$R_t = b_0 + b_1 X_{t-1} + b_2 X_t + b_3 X_{t+1} + e_t$$

where Rt= Stock return in year t, , Xt-1= EPS in year t-1 divided by the share price at the beginning of year t, years t+1 to t+1 divided by the stock price at the beginning of year t. Rt3 is the aggregate stock return in year t+1. The expected results are: Past profit coefficient (b1) can be predicted as negative, ERC (b2) can be predicted as positive, FERC (b3) can be predicted as positive, future return coefficient (b4) can be predicted as negative.

Independent Variable

There are 2 independent variables used in the research, namely

a. Profit management

The earnings management variable adopts the earnings management used for the banking sector based on measurements carried out by Kanagaretnam's Model, et al. (2003) using while the Loan Loss Allowance (LLA with a modified model by Valdiansyah (2022).

$$\mathbf{LLP\ it = \alpha + \beta\ 1\ LLA_{it-1} + \beta\ 2\ NPL_{it-1} + \beta\ 3\ \Delta NPL\ it + \beta\ 4\ CI\ it + \beta\ 5\ LOAN\ it + \beta\ 5\ \Delta LOAN\ i\ t + \epsilon}$$

Where LLP is the nominal amount of provision for credit losses in the current year, LLAt-1 is the nominal amount of provisions for impairment losses in the previous year , NPL_{t-1} is the nominal amount of non-performing loans in the previous year, **ΔNPL it** is the change in non-performing loans in the year running, CO_{it} is the nominal amount of credit written off in the current year , $LOAN_{it}$ is the nominal amount of outstanding credit in the current year, **ΔLOAN i** is the change in the nominal amount of outstanding credit. All values for variables to measure earnings management are deflated against the total assets of the previous period. earnings management is the residual value from the equation above

b. Quality Auditors

Measurement for auditor quality uses the dami variable, namely 0 for companies that use non-big4 KAP and 1 for companies that use big4 KAP (Tarmidi et.al, 2021)

Moderating Variables

The moderating variable used is Return on Equity which reflects the ability of equity to generate profits. The formulation for calculating ROE is to divide net profit by total equity (Wulansari, 2018). There are two control variables in this study, namely company size using the log proxy of Assets and CAR, namely the model adequacy ratio. This research uses secondary data for banking companies listed on the Indonesian Stock Exchange. Sampling was carried out using a purposive sampling method, namely using the criteria of banks in Indonesia whose IPO was before 2017, publishing complete annual financial reports during the 2017-202 period. From the criteria above, 41 banks were selected for the 2017-2021 time period, namely for 5 years so that the total sample selected was 205 observations.

Data analysis method

To answer the problems posed in this research, a panel regression model is used which is expressed by the following equation:

$$FERC_{it} = \beta_{it} + \beta_1 EMi_{it} + \beta_2 KAis_{it} + \beta_3 ROE_{it} + \beta_4 EM*ROE_{it} + \beta_5 KA*ROE + \beta_6 Size_{it} + \beta_6 CAR_{it} + \varepsilon_{it}$$

Where:

$FERC_{it}$	=	Future Earning Response Coefficient i-th period
EM_{it}	=	Profit management of the i-th company in the t-th period
KAI_{IT}	=	Quality of auditors of the i-th company in eke-t period
ROE_{it}	=	Return on Equity of the i-th company in the t-th period
$Size_{it}$	=	Company size of the i-th company in the t-th period
Look for $_{it}$	=	Capital Adequacy Ratio of the i-th company for the t-th period
ε_{it}	=	Residuals of the i-th company in the t-th period

The panel model processing stages are carried out as 1) estimating the panel model which consists of the common effect model (CEM), fixed effect model (FEM) and random effect model (REM); 2) carry out chow test model selection testing to select the appropriate CEM or FEM model. If from the Chow test results the FEM model is selected, the Hausman test is continued to select the appropriate FEM or REM model and the final model decision is based on Hasuman's test. If from the Chow test results CEM is selected, it is followed by LM testing with the aim of selecting the appropriate model, namely CEM or REM and the final decision on the model used is based on the LM test results; 3) carry out theoretical hypothesis testing which includes testing the fit model with the determination coefficient, global testing with the F test and individual testing using the t test.

RESULTS AND DISCUSSION

Contents Results and Discussion

Descriptive statistics

The results of descriptive statistical processing can be seen in table 1. FERC produced an average value of -3.318, which means the market responded negatively to FERC for companies included in the banking industry group for the 2017-2021 period. The standard

deviation value of 65.171 indicates that there is quite a large variation in FERC scores between one bank and another. Management Earnings produces an average value of -2.93E-11, which means that overall companies in the banking industry carry out management earnings by reducing profits even though the intensity is relatively very small. Descriptive statistics for the Auditor Quality (KA) variable produces an average value of 0.533, which means that almost more than half of the companies in the banking industry have good auditor quality. The ROE variable produces an average value of 1.335%. With a standard deviation of 17.945, it shows that there is quite a large variation in ROE values between one company and another in the banking industry. Descriptive statistics for the CAR variable produce an average value of 26.289, which means that overall the companies included in the banking industry group have a good CAR, which is far above the required average CAR value, namely more than 8%. Size has an average value of 13.563, which means that the average banking company in Indonesia has total assets of tens of trillions.

Table 1. Descriptive Statistics

Variable	Mean	Std. Dev.	Maximum	Minimum
FERC	-3,318	65,171	452,600	-570,172
E.M	-2.93E-11	0.028	0.220	-0.055
KA	0.532	0.500	1,000	0,000
ROE	1,335	17,945	25,640	-95,440
CAR	26,189	17,801	169,920	9,010
SIZE	13,563	0.816	15,237	11,537

Source: processed data

Findings

The results of the Chow test show that the selected model is FEM because the p-value of the Cross section chisquare is 0.0047 < 0.05 as shown in table 2.

Table 2. Chow Test

Effects Test	Statistics	df	Prob.
Cross-section F	1.517253	(40,157)	0.0379
Chi-square cross-section	66.999508	40	0.0047

Source: processed data

The Hausman test was carried out because from the results of the Chow test FEM was selected. The results of the Hausman test obtained a p-value from random cross section of 0.0049 < 0.05 so that the model chosen was FEM compared to REM. Thus, the best model for testing the hypothesis proposed in this research is FEM.

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Table 3. Hausman Test

Test Summary	Chi-Sq. Statistics	Chi-Sq. df	Prob.
Random cross-section	20.351493	7	0.0049

Source: processed data

The processing results for the FEM model can be seen in table 4. The adjusted R^{2} value of 0.1484 shows that the variation of the independent variables, namely EM, KA, ROE, EM*ROE, KA*ROE, CAR and Size, is able to explain the variation of the dependent variable, namely FERC, of 14 .84% while the remaining 85.16% is variations from other independent variables that influence FERC but are not included in the model. The results of the global test (F test) produce a p-value of F statistics of 0.0054 < 0.05, which means that Ho is rejected and Ha is accepted, so it is proven that there will be at least one independent variable that has a significant effect on the dependent variable.

The results of testing hypothesis 1 (H1) show that EM is supported to have a significant negative effect on FERC. This can be seen from the estimated coefficient value of -46.719 with the p-value of the t statistic of 0.0204 < 0.05. These findings mean that if a company carries out earnings management, investors will have a negative reaction to the company's ability to earn profits in the future. The results of testing hypothesis 2 (H2) are shown by an estimated coefficient value of 16.45104. With the p-value of the t statistic of 0.0029 < 0.05, Ho is rejected and Ha is accepted so it can be concluded that it is proven that investors will give a positive reaction to the company's ability to generate earnings in companies that have good auditor quality compared to other companies. who have poor auditor quality. Profitability proxied by ROE produces an estimated coefficient of -0.121875, which means that ROE has a negative effect on FERC and is not statistically significant because the p-value of the t statistic is 0.0743 > 0.05. These findings indicate that ROE does not qualify as a moderating variable in the FERC model. Thus, automatically Hypothesis 2 (H3) and Hypothesis 4 (H4) which aim to test the influence of EM and KA on FERC which is moderated by ROE are not supported.

Table 4. Hypothesis Testing
Dependent Variable: FERC

Prediction Variables	Coefficient	Std. Error	t-Statistics	Prob.
C	101.6564	109.7676	0.926106	0.3558
EM -	-46.71900	19.93923	-2.343069	0.0204*
KA +	16.45104	5.443905	3.021918	0.0029*

ROE	-0.121875	0.067832	-1.796709	0.0743
EM*ROE	0.283798	1.845043	0.153817	0.8780
KA*ROE	0.069307	0.111083	0.623916	0.5336
CAR	0.058695	0.020320	2.888605	0.0044**
SIZE	-8.496110	8.177445	-1.038969	0.3004
R-squared	0.344640			
Adjusted R-squared	0.148449			
F-statistic	1.756659			
Prob(F-statistic)	0.005459			

Source: processed data

Contents of Discussion Results

Earnings management has a negative effect on FERC

The findings above indicate that Earning Management produces a negative reaction for the company in relation to FERC. This gives a signal that companies must maintain company performance without carrying out earnings management so that *sustainable business* can be maintained and improved. Earnings management actions, whether by increasing or decreasing profits, will be responded negatively by investors and if this is taken into account, the sustainability of the company's business in the future will become a serious problem.

Audit quality has a positive effect on FERC

Internal control within the company in running its business is a factor that must be maintained by the company. This control can be obtained from audit quality because the findings show that auditor quality is proven to have a positive influence on FERC.

ROE cannot yet be a moderating variable because the stability of ROE is still very vulnerable to external conditions. This is shown by the average value of ROE which is still very low, where the cause of unstable ROE is the condition of the Covid 19 pandemic.

CONCLUSION

Several conclusions that can be drawn from the results of this research are 1) Earning Management has been proven to have a positive and significant effect on FERC; 2) Audit quality is supported to have a positive effect on FER; 3) ROE is not supported to be a moderating variable in the FERC function so that the influence of EM and KA which are moderated by ROE on FERC is not supported.

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