



Research Paper

## Analysis of the Effect of Audit Quality on Earnings Management through Accounting Conservatism

Agung Nurmansyah  
(Sahid University of Surakarta, Indonesia)  
Corresponding Author: Agung Nurmansyah

**ABSTRACT:** This study aims to analyze the effect of audit quality on accounting conservatism, analyze the effect of audit quality on earnings management, analyze the effect of accounting conservatism on earnings management and analyze the effect of audit quality on earnings management through accounting conservatism. The analysis technique uses path analysis. The results of the analysis show that audit quality has no effect on accounting conservatism. Audit quality has an effect on earnings management. Accounting conservatism has a significant effect on earnings management. Audit quality has no effect on earnings management through accounting conservatism.

**KEYWORDS:** audit quality, accounting conservatism, earnings management

Received 06 August, 2021; Revised: 18 August, 2021; Accepted 20 August, 2021 © The author(s) 2021. Published with open access at [www.questjournals.org](http://www.questjournals.org)

### I. INTRODUCTION

The characteristics of the banking industry are different from the manufacturing industry and the service industry, because most of the banking capital (more than 80 percent) comes from customers, financial markets and funds outside the company, so the government needs to regulate the banking industry so that it can play a role in stabilizing the economic growth of a nation and develop to meet the needs of society. The banking sector is indicated to carry out earnings management actions, according to research by Setiawati and Naim (2001), Suwito and Herawaty (2012) and Masodah (2007) the banking sector in Indonesia is indicated to carry out earnings management actions in financial statements reported to Bank Indonesia as a supervisor in the banking industry. According to research Beaty et al., (1995) that earnings management activities in the banking industry are carried out by, among others, exaggerating loan provisions, reducing loan write-offs and recognizing abnormal realized gains on the securities portfolio. Earnings management behavior is very likely to occur in the banking industry and is confirmed by the research of Beaver et al., (1989).

The principle of conservatism is a prudent principle to an uncertain event and is used to reduce high optimism (belief) from company managers and company owners. The principle of accounting conservatism in companies is used in different or different capacities. What is important to determine the degree of conservatism in the preparation of corporate financial statements is the responsibility of all company managers and all groups within the corporation in providing information that is open, accurate, and does not mislead investors.

Earnings management will also be influenced by audit quality, audit quality can discourage earnings management behavior. Audit quality is an opportunity for an auditor when examining financial statements to obtain and disclose findings in the form of material deviations in financial statements (DeAngelo, 1981). Audit quality is seen as the ability to strengthen or improve the quality of financial statements reporting. Good audit quality can increase the confidence of investors so that the value of the company increases. Rusmin (2010) stated that a large public accounting firm (KAP The big-4) conducting an audit of financial statements will result in lower earnings management actions than a relatively small KAP (KAP non-the big-4). Public Accounting Firms (KAP) which are relatively large tend to avoid things that can damage the reputation of the KAP, such as managing greater profits from their clients. Relatively large accounting firms prefer conservative financial statements from clients (no intentional errors and omissions in the information reported by the company). According to Christiani and Nugrahanti (2014) stated that high-quality auditing is a tool to hinder good earnings management behavior, because the good name of the company manager will be damaged and the

value of the firm will be low if there are financial statements. misrepresented and exposed to the public. such as the management of greater profits from its clients. Relatively large accounting firms prefer conservative financial statements from clients (no intentional errors and omissions in the information reported by the company). According to Christiani and Nugrahanti (2014) stated that high-quality auditing is a tool to hinder good earnings management behavior, because the good name of the company manager will be damaged and the value of the firm will be low if there are financial statements. misrepresented and exposed to the public. such as the management of greater profits from its clients. Relatively large accounting firms prefer conservative financial statements from clients (no intentional errors and omissions in the information reported by the company). According to Christiani and Nugrahanti (2014) stated that high-quality auditing is a tool to hinder good earnings management behavior, because the good name of the company manager will be damaged and the value of the firm will be low if there are financial statements. misrepresented and exposed to the public.

Audit quality affects earnings management directly or indirectly through accounting conservatism. The board of commissioners influences the level of accounting conservatism policies implemented by corporations in the preparation of financial statements. The stronger the accounting conservatism policy, the company managers to carry out earnings manipulation activities (earnings management) through financial statements can be reduced. Large companies in preparing financial statements prefer to produce conservative financial statements, because it will increase the value of the firm and can reduce political costs.

## **II. LITERATURE REVIEW**

### **2.1. Accounting Conservatism**

Watts (2003) defines conservatism as a principle that prioritizes the prudent actions of company managers to report financial statements, where the corporation does not immediately recognize gains and assets, then immediately recognizes the measurement of transactions that cause losses and debts. The application of this principle causes financial reporting, especially the income statement, to be lower and the balance sheet higher because the reporting of debt will increase. In accounting conservatism, expenses are required to be recognized immediately compared to revenue recognition. The income statement looks lower because expenses must be recognized immediately compared to revenue, net income looks lower than it actually is. Furthermore, conservatism makes financial statements more pessimistic, this will reduce the attitude of excessive confidence from the users of the report. Based on Martani and Dini (2010), a less confident attitude is used to reduce the excessive optimism of company managers, especially those related to earnings management.

### **2.2. Audit Quality**

Agency theory explains that there is a relationship between company managers and company owners that is not always in line, so there is often a conflict of interest between the principal and the agent, this condition causes information asymmetry. The existence of information asymmetry can create the need for a neutral third party, namely the auditor to examine and provide assurance on the financial statements prepared by management (Ittonen, 2010). Quality audit results are used to reduce the risk of information (financial transactions) that are not credible and increase the credibility of financial statements for users of financial statements such as investors and lenders (Mgbane et al., 2012). According to research by Johnson et al., (2002) argue that good audit quality makes financial statements add value and makes a tool for investors to estimate the value of transactions in the capital market. An increase in audit quality is an auditor's activity not only as an early discovery of errors, but also as a means of detecting material misstatements in certain transactions or accounts.

Hayes, et al., (2005) stated that the definition of audit quality is based on technical and functional audit quality. Technical audit quality is the extent to which the audit meets consumer expectations with respect to the detection and reporting of errors and related irregularities that are audited by the company and its financial statements. Functional audit quality is defined as the extent to which the audit implementation process audits and communicates the results to meet consumer expectations. Meanwhile, according to De Angelo (1981) defines audit quality as an opportunity if an examiner in conducting an audit of financial statements finds findings and reports an error in financial statements and reports the findings to users of financial statements. The auditor's courage to report errors that exist in the financial statements depends on the independence of the auditor, while the auditor's competence determines the opportunity to detect errors. Competence can be measured from the ability of the auditor, for example the level of experience, specialization, and others. Meanwhile, independence is measured by the extent to which the auditor can act independently in conducting the audit process and providing an audit opinion.

### **2.3. Profit management**

According to Scott (2015) earnings management is the determination of accounting procedures, policies and methods by company managers from existing accounting standards, so as to increase the usefulness

or value of the firm. The understanding of earnings management can be divided into two, namely first, Opportunistic Manager as an opportunistic behavior of company managers to optimize their utility in welcoming compensation agreements, money contracts, and political costs and secondly Efficient Contracting is an activity carried out by companies to protect themselves as company managers and as a company in anticipating and reducing unpredictable events for the benefit of each group in an agreement.

**2.4. Hypothesis**

- H1 : Audit quality has an effect on accounting conservatism.
- H2 : Audit quality has an effect on earnings management.
- H3 : Accounting conservatism has an effect on earnings management.
- H4 : Audit quality affects earnings management through accounting conservatism.

**III. RESEARCH METHODS**

This research uses a population of all banking corporations listed on the Indonesia Stock Exchange (IDX) totaling 45 corporations taken from 2013 to 2017. The selection of the banking sector in this study is (1) Banking is an industry of trust, if lost trust will result in collapse a bank that under certain conditions can cause a domino effect in the banking industry, (2) the banking industry in Indonesia in 2019 amounted to 115, this number is the largest number of banks in Southeast Asia and even one of the largest in the world, (3) the banking industry is a very prudent industry with many regulations made to protect this industry, (4) The banking industry in Indonesia has a banking asset-to-GDP ratio of 55% as of the end of 2019 according to OJK. The number of samples in this study were 15 companies.

The data collection method in this research is documentation, namely selecting and combining facts related to the situation in the form of reviews, readings, newspapers, tabloids, minutes, agenda reports and others. The source of the documentation in this research comes from the annual reports of each corporation listed on the Indonesia Stock Exchange as of January 1, 2013 to December 31, 2017, through the official websites of listed banking companies, the Financial Services Authority (OJK), Bank Indonesia (BI. ) and the Indonesia Stock Exchange (IDX), the Indonesian Institute of Certified Public Accountants (IAI-KAP), various records, journals and digging using the internet to obtain data related to everything in this research.

Path analysis or path analysis intends to verify the direct or indirect impact of the independent variable on the dependent variable. Causality relationship may occur one or more independent variables affect directly or indirectly the dependent variable. The direct and indirect relationship by applying path analysis can be measured. This study uses SPSS 24 to answer the proposed hypothesis.

**IV. RESULTS AND DISCUSSION**

**4.1. Results**

Based on the results of the path analysis, it can be described as follows:  
Based on the results of the path analysis, it can be described as follows:

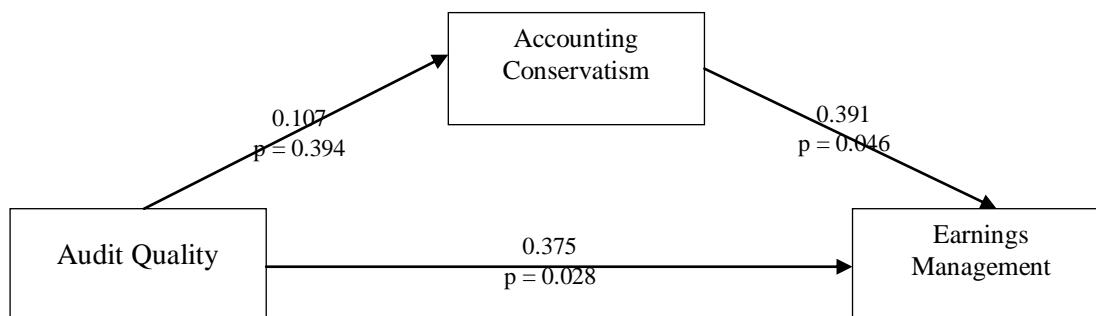


Figure 1. Path Analysis Results

## **4.2. Discussion**

### **4.2.1. Effect of audit quality on accounting conservatism**

Audit quality has no effect on accounting conservatism, because banking in Indonesia is closely monitored by the government through the OJK and Bank Indonesia. Tight supervision by the government causes banks to apply the precautionary principle so that audit quality does not have an impact on accounting conservatism. The audit conducted by KAP has been replaced by the government through the OJK through regular and occasional inspections. The results of this research are supported by research by Munif and Achmad (2013) which explains that accounting conservatism is not influenced by audit quality.

### **4.2.2. Effect of audit quality on earnings management**

Audit quality has a positive effect on earnings management, meaning that the increasing influence of audit quality, the less earnings management (earnings management) by the company. The results of this research are supported by the research of Makaombohe et al. (2014) shows that large corporations tend to be less likely to implement earnings management, because large corporations are monitored more carefully by shareholders and the government. The public sees the performance of relatively large banking companies so that companies will report more transparent financial statements and reduce earnings management policies.

Company size can affect audit quality. Large companies because of the complexity of operations and the increased separation between company managers and company owners, really need a KAP that can reduce agency costs. In addition, the increasing number of agency conflicts and complexity causes the demand to differentiate the quality of auditors also increases, so large companies will choose to use a quality KAP to produce quality audit reports compared to small companies (Berikang, et al., 2018).

Company size plays an important role when companies carry out earnings management activities. Small company sizes are considered to carry out more earnings management practices or activities than large companies (Medyawati and Dayanti, 2017). This is because small companies tend to want to show the condition of companies that always perform well so that investors invest their capital. In contrast to large companies, they will usually be more careful in reporting their financial statements, because large companies are more supervised by the public.

### **4.2.3. Effect of Accounting Conservatism on Earnings Management**

Accounting conservatism has a positive impact on earnings management (profit management), meaning that if accounting conservatism policies are implemented, the company or corporation will decrease earnings management behavior (profit management). The results of the study are supported by research by Kazemi et al., (2011) which states that the principle of conservatism is a principle to reduce the excessive optimism of company managers and reduce the tendency to be excessive in the preparation of financial statements. The results of this study are also supported by Nurmansyah et al. (2019) The implementation of accounting conservatism in reporting financial statements, especially profit and loss statements, can reduce the opportunity for company managers to commit earnings management fraud and can minimize conflicts of interest that occur between company management groups and company owners due to information asymmetry. According to Fala (2007) the attitude of accounting conservatism can reduce or avoid the behavior of opportunistic company managers by managing earnings for personal interests. If the management of the company manages profits, then accounting conservatism will be a barrier to carrying out earnings management activities (Haque et al., 2016), (Prabaningrat and Widanaputra, 2015) and (Haniati and Fitriany, 2010)

### **4.2.4. Accounting quality affects earnings management through accounting conservatism**

Agency conflict occurs because there is a dispute between the manager and the owner of the company due to an imbalance of information because the manager of the company has more information on the company's activities than the owner of the company. The assumption of individuals acting to maximize personal interests, where managers maximize their interests as well as company owners. Company managers to maximize personal interests (get bonuses) by hiding some information by manipulating accounting numbers in financial statements by means of earnings management.

Agency conflicts can be reduced by audit activities by public accounting firms that make for good audit quality. The agency theory of the audit function is a tool to reduce conflicts between parties, namely between company owners and company managers. The conflict between the owner of the company and the manager of the company wants the auditor to minimize data discrepancies between the two parties. The greater the agency dispute, the greater the agency costs, and the greater the expectation for qualified auditors. KAP to be able to provide audits, KAP prefers conservative financial statements because it reduces fraudulent acts of information reported by the company and reduces problems that can damage its reputation, such as the management of excessive profits by its clients, so that audit quality affects the accounting conservatism applied in the company's financial statements. The results of this study support Lee et al. 2006; and Padmawati and

Fachrurrozie 2015), according to Gerayli et al., (2011), Nguyen et al., (2019), and Christiani and Nugrahanti (2014) audit quality has an impact on profit management, and research by Haque et al., (2016), Prabaningrat and Widanaputra (2015) and research by Haniati and Fitriany (2010) state that accounting conservatism has an effect on earnings management.

## V. CONCLUSIONS

- 1) Audit quality has no effect on accounting conservatism. Audit quality has no effect on accounting conservatism, because banking in Indonesia is closely monitored by the government through the OJK and Bank Indonesia on a regular and regular basis. Banking in Indonesia basically has implemented the precautionary principle so that the quality of audits (performed by KAP) does not have an impact on accounting conservatism. The research is in line with research by Munif and Ahcmad (2013) that audit quality has no effect on accounting conservatism.
- 2) Audit quality has a positive effect on earnings management, meaning that the better the level of audit quality of a company, the less earnings management activities (profit management) carried out by company management. The research results are supported by the research of Makaombohe et al. (2014) shows that large corporations (having good audit quality) will decrease in earnings management activities, because large companies have a large number of agency conflicts and complexity causes the demand for different auditor quality (KAP) to also increase, then large companies will choose to use a quality KAP to produce quality audit reports and large companies will usually be more careful in reporting their financial statements,
- 3) Accounting conservatism has a positive effect on earnings management, meaning that an increase in the level of accounting conservatism will affect a decrease in the level of earnings management (earnings management) by the company. The policy of accounting conservatism becomes a barrier to opportunistic management or company managers in carrying out earnings management activities where earnings management activities (profit management) are related to personal interests.
- 4) Audit quality has a direct effect on earnings management, accounting conservatism is not influenced by audit quality, earnings management is directly affected by audit quality not through accounting conservatism.

## REFERENCES

- [1] Beatty, A., Chamberlain, S. L., & Magliolo, J. 1995. *Managing Financial Reports of Commercial Banks: The Influence of Taxes, Regulatory Capital, and Earnings*. Journal of Accounting Research, 231-261.
- [2] Beaver, W., Eger, C., Ryan, S., & Wolfson, M. 1989. *Financial Reporting, Supplemental Disclosures, and Bank Share Prices*. Journal of Accounting Research, 157-178.
- [3] Berikang, A., Kalangi, L., & Wokas, H. 2018. *Pengaruh Ukuran Perusahaan Klien Dan Rotasi Audit Terhadap Kualitas Audit Pada Perusahaan Manufaktur yang Terdaftar di Bursa Efek Indonesia Tahun 2012-2015*. Going Concern : Jurnal Riset Akuntansi, 13 (03).
- [4] Christiani, I., & Nugrahanti, Y. W. 2014. *Pengaruh Kualitas Audit Terhadap Manajemen Laba*. Jurnal Akuntansi dan Keuangan, 16(1), 52-62.
- [5] DeAngelo, L. E. 1981. *Auditor Size and Audit Quality*. Journal of Accounting and Economics, 3, 183-199.
- [6] Fala, D. A. S. 2006. *Pengaruh Konservatisme Akuntansi terhadap Penilaian Ekuitas Perusahaan Dimoderasi oleh Good Corporate Governance* (Doctoral dissertation, Universitas Gadjah Mada).
- [7] Gerayli, M. S., Yanesari, A. M., & Ma'atoofi, A. R. 2011. *Impact of Audit Quality on Earnings Management: Evidence from Iran*. International Research Journal of Finance and Economics, 66(1), 77-84
- [8] Haniati, S. Fitriany. 2010. *Pengaruh Konservatisme terhadap Asimetri Informasi dengan Menggunakan beberapa Model Pengukuran Konservatisme*. Simposium Nasional Akuntansi XIII, 1-28.
- [9] Haque, A., Mughal, A., & Zahid, Z. 2016. *Earning Management and the Role of Accounting Conservatism at Firm Level*. International Journal of Economics and Finance, 8(2), 197.
- [10] Haque, A., Mughal, A., & Zahid, Z. 2016. *Earning Management and the Role of Accounting Conservatism at Firm Level*. International Journal of Economics and Finance, 8(2), 197.
- [11] Hayes, R., & Dassen, R. Schilder?, Wallage P, 2005, *Principles of auditing-An introduction to international Standards on auditing*, Ed. Person Education Limited, Edinburg.
- [12] Ittonen, K. 2010. *A Theoretical Examination of the Role of Auditing and the Relevance of Audit Reports*.
- [13] Johnson, V. E., Khurana, I. K., & Reynolds, J. K. 2002. *Audit- Firm Tenure and the Quality of Financial Reports*. Contemporary Accounting Research, 19(4), 637-660.
- [14] Kazemi, H., Hemmati, H., & Faridvand, R. (2011). *Investigating the relationship between conservatism accounting and earnings attributes*. World Applied Sciences Journal, 12(9), 1385-1396.
- [15] Lee, P. J., Taylor, S. J., & Taylor, S. L. 2006. *Auditor Conservatism and Audit Quality: Evidence from IPO Earnings Forecasts*. International Journal of Auditing, 10(3), 183-199.
- [16] Makaombohe, Y. Y., Pangemanan, S. S., & Tirayoh, V. Z. 2014. *Ukuran Perusahaan Terhadap Manajemen Laba Pada Perbankan yang Terdaftar di Bursa Efek Indonesia Periode 2008-2011*. Jurnal EMBA: Jurnal Riset Ekonomi, Manajemen, Bisnis dan Akuntansi, 2(1).
- [17] Martani, D., & Dini, N. 2010. *The Influence of Operating Cash Flow and Investment Cash Flow to the Accounting Conservatism Measurement*. Chinese Business Review, 9(6), 1.
- [18] Masodah, M. 2007. *Praktik Perataan Laba Sektor Industri Perbankan Dan Lembaga Keuangan Lainnya Dan Faktor Yang Mempengaruhinya*.
- [19] Medyawati, H., & Dayanti, A. S. 2017. *Pengaruh ukuran perusahaan terhadap manajemen laba: Analisis data panel*. Jurnal Ilmiah Ekonomi Bisnis, 21(3).

- [20] Mgbame, C. O., Eragbhe, E., & Osazuwa, N. P. 2012. *Audit Partner Tenure and Audit Quality: An Empirical Analysis*. European Journal of Business and Management, 4(7), 154-162.
- [21] Munif, N. R., & Achmad, T. 2013. *Analisis Pengaruh Komite Audit Terhadap Hubungan Antara Rotasi Auditor Dan Audit Tenure Dengan Konservatisme Akuntansi* (Doctoral dissertation, Fakultas Ekonomika dan Bisnis).
- [22] Nguyen, L. Q. T., Le, D. T., Luu, H. N., Nguyen, A. H., & Hoang, T. G. 2019. *The role of audit quality in preventing firm misreporting: empirical evidence from China*. International Journal of Managerial Finance.
- [23] Nurmansyah, Agung, Widji Astuti, and Prihat Assih. 2019. The Effect of Corporate Governance on Earnings Management through Accounting Conservatism. *International Journal of Advances in Scientific Research and Engineering (ijasre)*. Volume 5, Issue 12: 41-47.
- [24] Padmawati, I. R., & Fachrurrozie, F. 2015. *Pengaruh Mekanisme Good Corporate Governance Dan Kualitas Audit Terhadap Tingkat Konservatisme Akuntansi*. Accounting Analysis Journal, 4(1).
- [25] Prabaningrat, I. G. A. A. dan A. A. GP. Widanaputra. 2015. *Pengaruh Good Corporate Governance Dan Konservatisme Akuntansi Pada Manajemen Laba*. E-Jurnal Akuntansi Universitas Udayana. Vol. 10 No. 3.
- [26] Scott, R. William. 2015. *Financial Accounting Theory 7nd Edition*. Prentice-Hall, New Jersey.
- [27] Setiawati, L., & Naim, A. 2001. *Bank Health Evaluation by Bank Indonesia and Earning Management in Banking Industry*. Gadjah Mada International Journal of Business, 3.
- [28] Suwito, E., & Herawaty, A. 2012. *Analisis pengaruh karakteristik perusahaan terhadap tindakan perataan laba yang dilakukan oleh perusahaan yang terdaftar di Bursa Efek Jakarta*.
- [29] Watts, R. L. 2003. *Conservatism in Accounting part I: Explanations and Implications*. Accounting Horizons, 17(3), 207-221.
- [30] Watts, R. L. 2003. *Conservatism in Accounting part II: Evidence and Research Opportunities*. Accounting Horizons, 17(4), 287-301.
- [31] Watts, R. L., & Zimmerman, J. L. 1990. *Positive Accounting Theory: a Ten Year Perspective*. Accounting Review, 131-156.