THE ROLE OF MANAGEMENT ENTRENCHMENT AND AUDIT QUALITY ON EARNING QUALITY: EVIDENCE FROM INDONESIA

Wisnu Mawardi, Universitas Diponegoro
Harjum Muharam, Universitas Diponegoro
Mulyo Haryanto, Universitas Diponegoro

ABSTRACT

The purpose of this study was to determine the role of management entrenchment and audit quality on earnings quality. The population in this study are mining sector companies listed on the Indonesia Stock Exchange (IDX) in 2017-2020. The sample selection in this study used a purposive sampling method with a research sample of 168. The results of regression analysis using the SPSS 26 program showed that the variables of management entrenchment, audit quality, profitability, and firm size affected earnings quality. However, the leverage variable does not affect earnings quality.

Keywords: Management Entrenchment, Audit Quality, Earning Quality.

INTRODUCTION

Financial reports are a communication medium for companies as they can connect related parties with the company both internally and externally. The benefits of the annual report are huge for users, but there is the most important part in them, which is earning information can helpful for investors to assess the earning quality of affiliated companies. Good profits are an incentive for investors to make decisions about whether to invest or not (Arkan, 2016). The importance of profit-related information to users creates investor expectations so that the profits presented are truly real. The earning quality is not measured by the amount of profit generated by the company, but by how the company can present the actual state of the profits made by the company. This condition causes business leaders to compete to increase their profits. Some managers sometimes take unhealthy measures to achieve their desires, including measures to control earnings. Anwaar (2016) showed that earning information is often manipulated by management for personal gain. This is done to get the attention of investors or other parties. This of course leads to the earnings quality itself, a low earnings value harms investors and the resulting deals are not of high quality due to manipulation (Abbadi et al., 2016).

Several cases related to earning quality, for example in the case of PT. Timah (Persero) Tbk in 2017. This mining company is a state-owned company in Indonesia. It is known that the board of directors of PT. Timah allegedly lied to the public by saying that efficiency and policy resulted in a good performance in the first half of the 2017 financial statements. However, the first half of 2017 saw a loss of Rp. 50 billion. The debt has even increased by up to 100% compared to the previous year. The phenomenon of the loophole mentioned above illustrates that their accounting practices contradict the real earnings quality. These actions are also classified as

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opportunistic actions that occur because the principal prioritizes his or her wellbeing or is commonly referred to as management entrenchment.

Management entrenchment is a conflict between the agent and the principal in which the principal wishes to assert his position by taking advantage of the situation and sacrificing the interests of other parties. Chen et al. (2020) found that family businesses often experience deterioration in the earnings quality so that their existence can lead to management becoming entrenched. A survey of family businesses in Indonesia carried out by the American accounting firm PwC shows that there are companies in Indonesia, 95% of which are family businesses. This differs from García-Sánchez et al. (2020) found no effect between management entrenchment and earnings quality as many financial reports fail to mention the length of the CEO's tenure. The greater the difference between control rights and cash flow rights of various shareholders, the higher the probability that the company will appoint a KAP with low audit quality. Reliable audit quality will certainly reduce conflicts between the company's shareholders.

The audit quality received by the company depends on the auditor's ability to find errors/fraud in the company's financial statements. The audit quality of therefore depends heavily on the auditing firm selected by the company on the recommendation of the company's audit committee. This research uses mining companies as research objects because Indonesia is among the top 20 countries with the largest mining production in the world. Next, mining made a very high contribution in terms of foreign direct investment, in some countries mining contributed to exports, and mining also contributed to bringing in foreign currency. The mining sector's earnings growth was also 23% higher than in other sectors in 2018. This study aims to investigate the role of management entrenchment and audit quality on earning quality.

LITERATURE REVIEW

Earning Quality

Earnings quality is important information used by the public or investors in calculating the company. The high and low quality of earnings that the company generates is useful as a basis for taking action. Because if earnings are of good quality, this shows that the company's actual performance is also helping investors to make the right decisions. In addition, earnings quality is also useful for assessing current or future performance. According to Rezaee & Tuo, (2019), there are 3 characteristics of quality earnings, namely:

1. Can show the current operational capabilities of the company accurately.
2. Can show the correct parameters regarding the company's future capabilities.
3. Can be used as a parameter to assess the company's ability.

Audit Quality

DeAngelo (1981) said that *"audit quality is a market assessment of opportunities to investigate and report material deviations by the auditor in the annual report"*. Titman & Trueman (1986) consider the accuracy and soundness of the information published by auditors as criteria for the audit quality. According to DeAngelo (1981) using criteria or indices that are directly related to audit quality is very economical in terms of time and cost to measure audit quality that cannot be observed. In addition, larger audit firms are also more likely to maintain

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their reputation in the community, resulting in higher quality audits of client's financial statements. In general, we can see that larger audit firms have more and more customers, which leads to the independence of the clients so that the bargaining power of these companies is greater than that of the small companies.

Management Entrenchment

According to Di Meo et al. (2017) management entrenchment is a conflict between the authorities, either between majority and minority shareholders or management and shareholders. According to Piosik & Genge (2020), the controlling shareholder is the party that has the power to oversee the company. Because of their power, they can abuse power (management entrenchment). According to García-Sánchez et al. (2020), a manager with management entrenchment is usually in a supportive situation. The management of the management entrenchment process is described by Fagbemi et al. (2020) as a process that enables managers (CEOs) to free themselves from the control of the board of directors, the audit committee, or even the company's shareholders.

Hypothesis Development

Effect of management entrenchment on earnings quality

The management entrenchment is supported by the position of a person in the company and the length of the service period of a person. Likewise, with the length of the tenure, someone who has worked for a long time in a company naturally knows the company better and has many relationships. So, it is easy for them to implement guidelines. This is in line with the opinion of (Di Meo et al., 2017). Where the stronger management entrenchment causes a lower-earning quality. The rootedness of management is evident in the length of time that the position of CEO has been filled CEO Tenure. Because the longer you are in office, the more likely it is that a person will have more connections and easier access. This study shows that management entrenchment has an impact on earning quality. These results relate to the research by Di Meo et al., (2017) In his opinion, a high level of management entrenchment tends to lead to a lower earnings quality. Because it is not exposed according to reality because of the authority it has. Although it will have positive or negative effects.

H_1 Managerial entrenchment has a significant effect on earning quality

Effect of Audit Quality on Earnings Quality

The high audit quality gives investors the hope of receiving shares in reliable companies. A good audit also prevents companies from breaching financial statements, fraud, and creative accounting (Sari et al., 2020). Managers as rulers have the right to determine the measures to be taken. These actions can lead to positive or negative things. The existence of the auditor as an auditor thus plays a very important role. This is because there is a difference of interest between the principal and the agent. Therefore, an independent party is required to ensure that the procedures and results of the financial statements comply with applicable standards. From the results of a quality audit, which instills confidence among investors, they assume that the profits are good and credible. A poor audit quality leads to a deterioration in the quality of the reported results. As a result, if manipulation is proven, the value of the company and its reputation decrease (Chabachib et al., 2019). The research hypothesis shows that audit quality affects the

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quality of results. Audit quality is measured by the membership of the Big Four and Non-Big Four KAPs. Non-Big Four firms have better reputations, so the audit reports they produce are also better than non-Big Four KAPs (Alhadab & Clacher, 2018; Utomo et al., 2019).

H_2 Audit quality has a significant effect on earning quality

Effect of Leverage, Profitability, and Firm Size on Earnings Quality

According to Sumail (2019) companies' high debt conditions have an impact on the quality of the profits achieved, since the company's debt conditions can trigger earnings control. Agency theory suggests that this revenue control condition triggers differences in interests between the principal and the agent. On the other hand, having debt can improve the company's performance as the company has dependents who need to be completed. Debt can also improve the quality of returns as debt can be used as capital to generate higher profits. High profitability, is a positive signal for investors as they are more interested in the company. The higher the profitability, the higher the quality of the return that is the goal of investors. Because the high profit achieved determines the amount of the dividends distributed. The bigger the company, the easier it is to generate earning, then these funds make it easier for the company to improve its business operations, which will later also have an impact on the increase in profits. Large companies have a responsibility to meet investor expectations for them to try to improve the quality of their returns. Chabachib et al. (2019) has shown that company size is a factor influencing the quality of company profits. Since large companies are usually able to overcome the risks, good corporate governance, supported by good human resources (HR), is required. So that they can properly manage the company's assets make a profit (Figure 1).

H_3 Leverage has a significant effect on earning quality

H_4 Profitability has a significant effect on earning quality

H_5 Firm size has a significant effect on earning quality

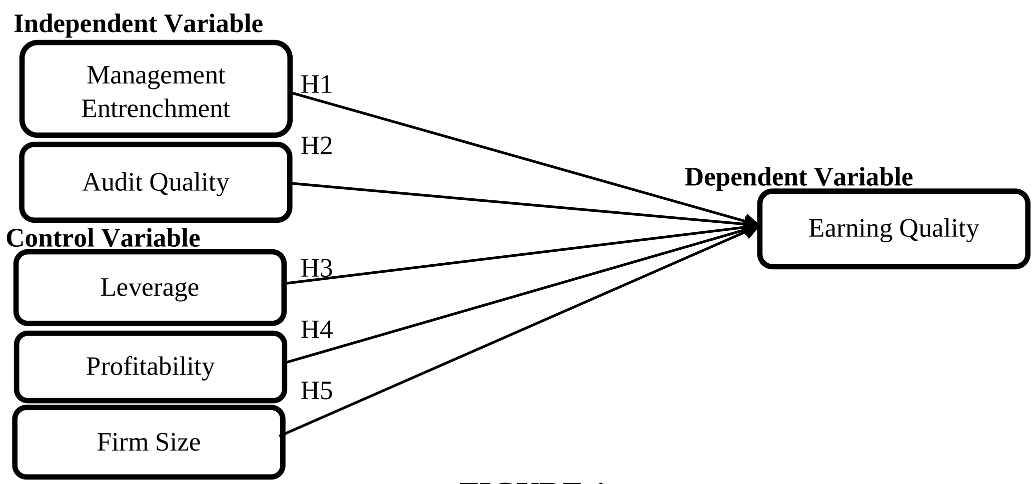

FIGURE 1
RESEARCH MODEL

METHODOLOGY

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This study uses the nature of the data in the form of secondary quantitative data. In this study, descriptive statistics, the classic acceptance test consisting of normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test were used as data analysis. Then multiple regression analysis, then hypothesis test with the F-test and t-test and the coefficient of determination test. Operational definitions of variables are presented in Tables 1 & 2 as follows:

Table 1
VARIABLE OPERATIONAL DEFINITION

Variable	**Indicator**	**Scale**	**Source**
Management Entrenchment (X1)	CEO Tenure -If there is no change of CEO for 3 periods (0) -If there is a change of CEO for 3 periods (1)	Ratio	García-Sánchez et al. (2020)
Audit Quality (X2)	KAP Non-Big Four (0) KAP Big Four (1)	Ratio	Alhadab & Clacher (2018)
Earnings Quality (Y)	Modified Jones' discretionary accruals are as follows: (a) Total accruals TACit = EBXTit-OCFit (b) Then estimate the company-specific parameters, then the regression analysis model is obtained OLS (Ordinary Least Squares) Calculated by the formula: TACit/TAi,t-1 = 1(1/TAi,t-1) + 2(ΔREVit /TAi,t-1) + 3(PPEit/ TAi,t-1) Information: TACit: Total accruals in year t EBXTit: Net profit of company i in year t. OCFit: Cash flow from operating activities of a company i in year t. TAi,t-1: Total assets of a company I at the end of year t-1. REVit: Change in revenue of company i from year t-1 to year t. RECit: Change in net receivables of a company I from year t-1 to year t. PPEit: Gross property, plant and equipment of company i in year t 1, 2, 3: Jones model regression coefficient: error. (c) Using the regression coefficient above the Non-Discretionary Accruals (NDA) value can be calculated by the formula: NDACit=1(1/TAi,t-1)+2((ΔREVit-RECit)/TAi,t-1)+ 3(PPEit/TAi,t-1) Information: NDACit: Non-discretionary accruals in year t. (d) Furthermore, Discretionary Accruals (DA) can be calculated as follows: DACi = (TACit / TAi,t-1) – NDACit Information: DACit: The company's discretionary accruals in year t.	Nominal	Utomo (2019)
Leverage	DER= Total Debt / Owner's Equity	Nominal	Yuniningsih et al. (2019)
Profitability	ROE= Earnings Before Interest and Tax (EBIT) / Owner's Equity	Nominal	Arora & Sharma (2016)
Firm Size	Size = Ln Total Asset	Nominal	Zhai et al. (2020)

Source: Secondary data processed in 2021

Table 2
SAMPLE DATA

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Information	Number of Companies
Mining companies listed on the IDX in 2017-2020	264
Mining companies that do not have the necessary variables	(99)
Amount of data according to sample	168

Source: Secondary data processed in 2021

RESULT

Based on Tables 3 & 4, multiple linear regression equations in this study are:

$$DA = 689998.290 + 49396962412.384\ ME + 37044778535\ AQ + (-0.006)\ LEV + 204.395\ PROF + (-21.374)\ SIZE$$

Where, DA=Discretionary Accrual; ME=Management Entrenchment; AQ=Audit Quality; LEV=Leverage; PROF=Profitability; SIZE=Firm Size

Table 3
DESCRIPTIVE STATISTICS

	N	Minimum	Maximum	Mean	Std. Deviation
X1 (Management Entrenchment)	168	0	1	0.74	0.439
X2 (Audit Quality)	168	0	1	0.40	0.492
Y (Earnings Quality)	168	-745696720835	9040337116543	-411662026649	7406069385560
C1 (Leverage)	168	-15435381	57157	-149153.21	1506654.598
C2 (Profitability)	168	-9331381343	8654188379	243877392.34	1774437807.517
C3 (Firm Size)	168	2785525	3186572155	2350462864.83	855058723.735
Valid N (listwise)	168				

Source: Secondary data processed in 2021

Table 4
MULTIPLE LINEAR REGRESSION TEST RESULTS

Model	Unstandardized Coefficients		Standardized Coefficients
	B	Std. Error	Beta
(Constant)	689998.290	365445.370	
C12	-0.006	0.016	-0.006
X12	49396962412.384	15069387120.153	1.094
X22	37044778535.127	2311422054.585	0.738
C22	204.395	38.740	0.528
C32	-21.374	6.484	-1.295

Source: Secondary data processed in 2021

DISCUSSION

Management Entrenchment on Earnings Quality

Management entrenchment has a significant effect on earnings quality. Thus, H1 is accepted. This shows that the level of management entrenchment proxy by CEO tenure affects earnings quality. Because the longer the CEO is in office, they tend to increase the firm value they lead, because they believe that the success of the company will also have an impact on their success. And vice versa, the destruction of the company will also affect their careers. So, that as much as possible they carry out their responsibilities by company expectations, even with entrenchment actions (Di Meo et al., 2017). The negative impact of management entrenchment will occur if the control rights owned are used for their interests. And this will also affect the selection of a Public Accounting Firm. Namely by choosing a non-Big Four KAP, to reduce the

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transparency of the company, for its own sake. This agrees with the research of Di Meo et al. (2017) who found that management entrenchment affected earnings quality.

Audit Quality on Earnings Quality

Based hypothesis result shows that audit quality has a significant effect on earnings quality. Audit quality influences earnings quality because Big Four KAPs tend to have better abilities and reputations in auditing companies. The auditors who work in Big four KAPs are well-trained subjects, with better education and experience than Non-Big four KAPs. So that in detecting errors, they have a much better understanding, therefore errors in financial statements, especially the decrease in earnings quality can be minimized. Big four KAPs have a better ability to audit financial statements. For the most part, the Big four KAPs are international-class KAPs. This is believed by many companies, so companies believe that the Big four KAPs that have a good reputation tend to produce audit reports that are truly quality. Where the potential for fraud in the auditing process is very low. So that the company will provide real financial reporting, with procedures according to standards (Irwandi & Pamungkas, 2020).

The results of this study agree with agency theory and signal theory. There are different interests in the company. The agent must work according to the will of the owner. Though agents also have different motivations. This causes conflicts between them based on differences in interests and information asymmetry. In line with this theory, the entity will appoint a KAP that has a good reputation to convince investors and form a good image for the company. The results of this survey agree with the research of Alhadab & Clacher (2018) which suggest that audit quality affects earnings quality. Where the company's earnings quality problems can be overcome by supervision of the implementation of the audit. Good audit quality can also harmonize different interests in terms of earnings quality.

Leverage, Profitability and Firm Size on Earnings Quality

The third hypothesis in this study was rejected, because when viewed from descriptive statistics, generally the sample companies have safe leverage and the ability to pay off the debt. So managers are not interested in taking actions that affect earnings quality reveal that several things affect the security of debt agreements, namely, credibility, promised guarantees, and installment payment times (Wasan & Mulchandani, 2020). Although the presence of high leverage can increase the risk for the company, leverage does not affect the earning quality, because the high leverage ratio and high risk cannot guarantee the earning quality in the future. Leverage does not affect earnings quality, indicating that the debt is used more in its capital structure, so investors have less confidence in the profits generated. High profits indicate a lack of capital in the company, the company must seek funds from external parties to carry out operations so that they run well. The existence of high profits can spur companies to run dynamically, and improve their performance, so that debts are paid off, and get bigger profits. The results of this study agree with the research of Cuong & Canh (2012) who found that the leverage control variable did not affect earnings quality.

The fourth hypothesis in this study is accepted. High profitability shows how the company's performance during the period, so that through good profitability, investors will believe that the profit/loss report produces such quality earnings. In line with signal theory. That the information provided by the company related to investment is what investors have been waiting for and trusted. High profitability shows good earnings quality, so the company can bear

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the burden it has (Lucia & Panggabean, 2018). Profitability is said to affect earnings quality, because investors make the company's profit the first measure in investing, high profitability indicates high earnings quality, so it can be seen that the performance of the related company has potential (Abdo, 2021).

The fifth hypothesis in this study was accepted. The larger the company makes the company in the spotlight of shareholders and outsiders so that the larger company makes company more logical and accurate in presenting its financial statements (Monteiro et al., 2021). Big companies are not necessarily able to provide large wages and large dividends. However, investors tend to choose stocks that are by market conditions, not relying on the size of the company. It is in line with a signal theory where the signals are given can produce benefits. Large companies generally have information or components that are more complex than small companies. From the figures and components in the financial statements issued, the company sends its signal to external parties, which is good news for investors (Table 5).

Table 5
t Test Results

Hypothesis	t count	Sig.	Standar	Conclusion
H1	-0.362	0.718	0.05	Rejected
H2	3.278	0.002	0.05	Accepted
H3	16.027	0.000	0.05	Accepted
H4	5.276	0.000	0.05	Accepted
H5	-3.296	0.002	0.05	Accepted

CONCLUSION

Management entrenchment affects earnings quality. This shows that the level of management entrenchment will affect the increase or decrease in the quality of the company's earnings. Audit quality affects earnings quality. This shows that the higher the audit quality of the company, the higher the quality of the company's earnings. Big four or non-Big four KAP categories can also affect the company's audit quality. The control variables of profitability and firm size affect earnings quality. However, the leverage control variable does not affect earnings quality.

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