

THE INTERACTION EFFECT OF CLIENT BARGAINING POWER AND AUDITOR INDUSTRY SPECIALIZATION ON EARNINGS MANAGEMENT OF INDONESIAN COMPANIES LISTED IN BEI ¹

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ABSTRACT

This study aims to examine the interaction effect of firm size, as the proxy for client bargaining power, and auditor industry specialization on the magnitude of earnings management among public listed companies in Indonesia. The sample of the study covers 5 years observations of public listed companies in the Jakarta Stock Exchange in 1998 - 2003 in all industries except banking and financial institutions. There are 162 companies meet the sampling criteria. The final samples consist of 603 firm years which restricted for only the client of Big N affiliated audit firms in Indonesia. The analyses are applied using single pooled regression. The result of the regression suggested that the firm size negatively affect the magnitude of earnings management. This finding confirms the monitoring theory that the larger the firm the more sophisticated control mechanism and, hence, the lower level of opportunistic agent's behavior. The auditor industry expertise is not found to be a quasi moderator variable on the association between earnings management and firm size. The positive sign of the interaction term indicates the higher bargaining power in term of economic dependence and complexity inherent on larger client served by auditor industry specialist in Indonesia.

Keywords: earnings management, discretionary accruals, client bargaining power, auditor industry specialization.

INTRODUCTION

Earnings management is a purposeful intervention by management in the earnings determination process (Schipper, 1989, quoted by Wild et al., 2003). Despite of its usefulness, the literature proposes that the managers' opportunities and incentives for managing earnings possibly turn to be aggressive and opportunistic such as manipulating accruals without any cash flows consequences. Moreover, it undermines the reliability of information contained on reported earnings and emerge 'noises' in assessing the true economic performance. Krishnan (2003a) stated that discretionary accruals often contain noise caused by manager's aggressive and opportunistic reporting.

From the accounting standard perspective, the flexibility and judgment that allowed in generally accepted accounting principles provide loopholes lead to earnings management practice. For example, managing accruals accounts, or capitalizing the research and development expenses without reasonable level of certainty. Those practises lead to the misleading information concerning true corporate performance.

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Though stated obviously that auditor is not responsible for management's reports, any cases related to misleading published financial statements possibly drag the auditor into the court (see Enron case). In Indonesia, this kind of case had emerged seen on published news. One topic is the mark up indicated on Kimia Farma's earnings for about 32 billion rupiahs in 2001. Both the management and its auditor, Hans Tuanakota and Mustofa, confessed that it is a matter of misstatement because of the subsequent discovery fact detected on the next audit engagement (Auditor, 2002). Another spot came from Lippo case with its two different versions of post audit financial statements within the same period (Auditor, 2003). Regarding the compliance of accounting and professional standards, 10 audit firms in Indonesia also got sanctions because of the standard violations (Edi, 2002). Those cases have attracted public and academic attention concerning auditor and client relationship.

From the auditor side, client size represents client bargaining power and complexity (Casterella et al. 2004). The larger the client size, the higher client bargaining power to its auditor and the more economic dependence of auditor. Economic dependence is termed as an incentive for auditor to compromise their independence and report favorably in order to retain client (Reynolds et al. 2001). The empirical evidences report the mix results concerning the relation between client size and auditor reporting decision. Reynolds et al. (2001) found no evidence that economic dependence causes Big Five auditors to report more favorably for larger clients, conversely, Big Five auditors report more conservatively for larger clients. In contrast, Carcello et al. (2004) found that the negative relation between auditor industry specialization and financial fraud is weaker for larger client. Their finding provides evidence that auditor independence in deterring financial fraud is affected by client size.

This study aims to investigate earnings management in Indonesia regarding firm size and audit quality performed by auditor industry specialist. Audit quality is taken to predict the magnitude of accrual-based earnings management based on previous researches (e.g. Becker et al. 1998; Krishnan 2003b; Balsam et al. 2003 Aloysia 2003; Inten 2004). Auditor industry specialization is proposed as another proxy for audit quality since the Enron debacle. The use of this proxy may give different approach to examine the condition of audit service in Indonesia.

Krishnan (2003b) suggested that auditor's industry expertise mitigates earnings management and therefore, enhances the credibility of financial reports with respect to management's opportunistic discretion. According to Sharma et al. (1981), this study also aims to examine whether auditor industry specialization is a quasi moderator on the relation between firm size and the magnitude of earnings management.

This study takes into account controls variable suggested to affects the magnitude of discretionary accruals which is a proxy for earnings management. These control variables are the absolute discretionary accruals, cash flow from operation, and the dummy variable of reported earnings (1 for reported net loss, and 0 otherwise).

The contribution of this study is twofold. It contributes to earnings management literature by considering external auditor who provides assurance service in examining management performance. Moreover, the auditor is accounted to be a quasi moderator variable that affects the relation between firm size and earnings management. This study contributes to audit quality literature by employing another dimension of audit quality which called auditor industry specialization according to the condition in Indonesia.

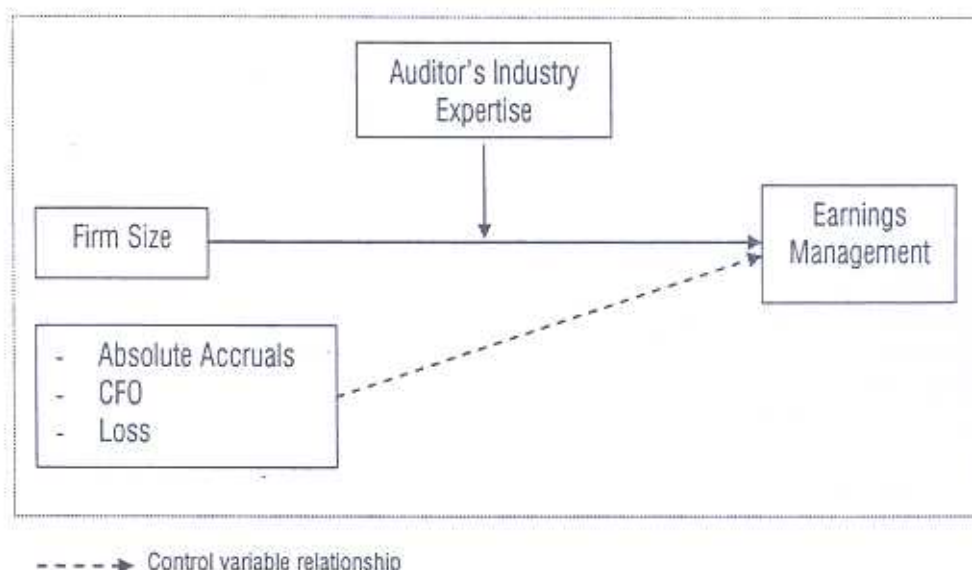
LITERATURE REVIEW

The relation of firm size and earnings management

Two opposing arguments are available concerning opportunistic behavior of manager within certain firm size. Kim et al. (2003) have developed argument concerning the relation of firm size and earnings management. Large firms are more politically sensitive and tend to manage earnings. Managers of these firms decrease earnings to minimize the obligation to transfer wealth (Watt and Zimmerman, 1986). Carcello et al. (2004) found that the fraudulent of financial reports are more likely to occur on large firms. In which, it indicates the more earnings management practise on large firms. Conversely, monitoring theory suggests that large firm possess resources that make it possible to develop sophisticated monitoring mechanism. And hence, it keeps manager to walk align with the interest of stakeholders and reduce earnings management incentives. Those arguments above lead to the following alternative hypothesis.

H1a: Firms size affects the magnitude of earnings management

Figure 1 Theoretical Framework



The relation of auditor industry specialization and earnings management

Another predictor for earnings management comes from independent auditors. They contribute to the monitoring mechanism that pressure the manager to report the true firm's economic condition by checking, assessing the reliability of management's report and ensuring whether calculation done in accepted procedures. By this, the agency cost, which is principal's monitoring cost, reduced. Myers et al. (2003) noted that high audit quality mitigate more extreme management reporting decisions and suggested that accruals can be used to identify the extreme reporting decisions.

Previous researchers (Teoh and Wong, 1993; Becker et al., 1998; Krishnan, 2003a; Meutia, 2004) had proposed audit firm size as dimension of audit quality. They suggest that large audit firm serve for higher audit quality as seen on the output of audit process; that is the higher earnings quality. But, the Enron debacle had made this approach improper since the Arthur Andersen involvement. There is also argument that audit firm size is less suitable proxy for audit quality in Indonesia (Sylvia and Siddharta, 2005). Therefore, this research employs auditors' industry expertise as a proxy in investigating audit quality. Furthermore, academic research concerning this proxy is still rare in Indonesia.

Auditors' industry expertise is termed as the tendency of individual accounting firm to dominate specific industry (Carcello et al., 2000). Given the assumption that the dominant audit suppliers provide better monitoring and have greater expertise relative to other audit supplier, industry specialist auditor should perform the higher audit quality. This domination could vary across country (Ashbaugh and Warfield, 2003; Krishnan, 2003b), including in Indonesia.

The findings of Krishnan (2003b) and Balsam et al. (2003) suggested that auditor's industry specialization, which is the proxy for auditor's industry expertise, enhance the credibility of reported discretionary accruals by minimizing noise contained on it. A negative association between auditor's industry specialization and discretionary accruals been found, meaning that auditor enhances the earnings quality in term of increasing the credibility of financial reports indicated by the lower level of discretionary accruals. The findings of Krishnan (2003b) and Balsam et al. (2003) lead to the following alternative hypothesis.

H1b: Auditor industry specialization decreases the magnitude of earnings management.

The moderating effect

Regarding the auditor and client relationship, Reynolds et al. (2001) suggested that it equals to the trade-off between auditor economics interest and reputation cost. Auditor will better able to retain clients by allowing clients discretionary items. Moreover, utility theory suggested that people analyze the cost and benefit of complying regulated practice (Becker, 1968), and this theorem is applicable to auditors too. When the auditor considers the less probability of indictment against him, he is more likely to acquiesce the attempts of larger clients to employ aggressive accounting treatments. Then, the auditor gets benefit in term of fee and audit re-engagement.

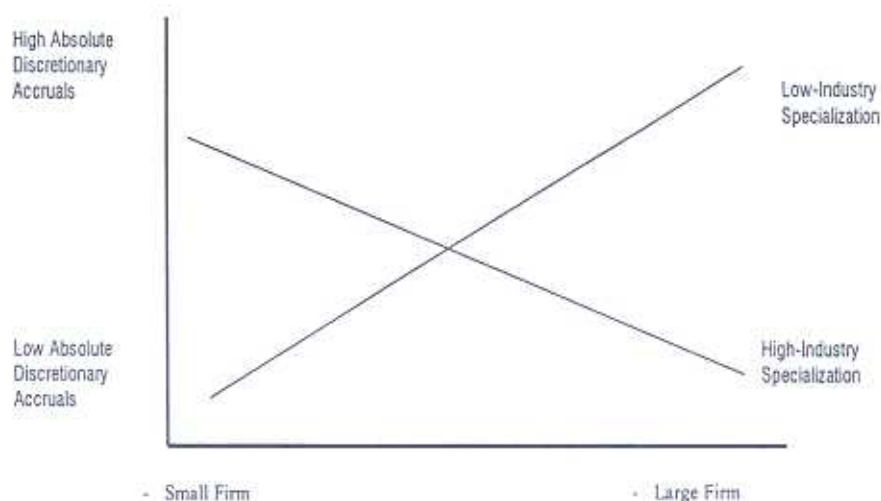
The size of the firm represents the economic resource owned by certain companies. From auditor's side, the size of the client represent client's bargaining power, further offer economic interest, to its auditor. It also may be more difficult for an auditor to possess industry expertise for larger clients who are likely to be more complex and operate in more than one industry (Carcello et al., 2004). By definition, industry specialist auditor is better able to detect the misstatement and other non-compliance behavior of its clients. Concerning earnings management, the question arise is whether

industry specialist auditor acquiesce aggressive earnings management practise regarding clients' size. Those arguments lead to the following hypothesis.

H1c: Auditor industry specialization affects the relation between firm size and the magnitude of earnings management.

The interaction effect of auditor industry specialization and client size on the magnitude of earnings management is visualize on figure 2 below.

Figure 2
The interaction effect of auditor industry specialization and firm size on earnings management



RESEARCH METHOD

Sample Selection

The population are those companies listed on the Jakarta Stock Exchange. The samples have to fulfil the following criteria.

1. Samples are public listed companies on the Jakarta Stock Exchange except financial and banking institutions. There are 333 companies in the 2004 Indonesian Capital Market Directory. After eliminating banking and financial institution, the sample amounted to 271 companies.
2. The data of these companies are available for five years observations, in other word they are not companies doing IPO during the periods. These second criteria decrease the sample into 207 companies.
3. This study excludes companies that exercise merger and acquisition during the period. Collins and Hribar (2002) and Nagy (2005) suggested that the indication of earning management with the occurrence of mergers, acquisition and discontinued operation cause

bias result. In this condition, researchers are likely to conclude that earning management exist when there is none. This requirement decreases the sample into 201 companies.

4. The selected companies must employ the financial years from January to December because changing financial year would raise a problem in estimating the discretionary accruals. The forth requirement decreases the sample into 198 companies.
5. There are 36 companies with incomplete data and it decreases the sample into 162 companies. For five years observations, there are 810 firms years fulfilling the criteria. After eliminating outlier and non-Big N client, the final sample amount to 603 firm years.

This research employs post-audit financial reports of public listed companies on the Jakarta Stock Exchange available on the JSX Corner of UNDIP, the Indonesia Capital Market Directory and www.jsx.co.id.

Variable and its measurement

The definition of each operational variable is as follow.

Table 1
Operational of Variables

Name of Variables	Definitions
<u>Dependent Variable:</u> $AbsDacc_{it}^*$	The absolute value of discretionary accruals, a proxy for the magnitude of earnings management estimated using the Jones-modified version (Dechow et al, 1995).
<u>Independent Variables:</u> $Spec_{it}^*$	Auditor industry specialization, estimated using the portfolio of clients of audit firm i during 1999 until 2003. This estimation was adapted from Krishnan (2003b).
$Size_{it}$	Firm size, which measured using the log of total assets of firm i in the year t .
$Size_{it} * Spec_{it}$	The firm size and auditor industry specialization interaction of firm i in the year t .
$AbsAccr_{it}$	The absolute value of accruals, calculated as the difference between net income and cash flow from operations of firm i in the year t .
CFO_{it}	Cash flow from operation of firm i in the year t .
$Loss_{it}$	Loss condition equals 1 if net income is negative, 0 otherwise.

*) Note : 1. Discretionary accruals is the residual value of the equation below.

$$(TA_t)/(A_{t-1}) = \alpha_1(1/A_{t-1}) + \alpha_2(\Delta REV_t - \Delta REC_t)/(A_{t-1}) + \alpha_3(PPE_t)/(A_{t-1}) + \varepsilon_t$$

Total accruals (TA_t) are calculated as the difference between net income and cash flow from operations.

2. Auditor industry specialization is measured using two sepcification. It equals to the percentage of portfolio share (continuous measurement). Auditor is also determined as industry specialist if the share on certain industry exceeds its average share. Auditor industry specialist is coded 1 and 0 otherwise (dichotomous measurement).

Statistical Justification

This study employs Sharma et al.'s (1981) steps to identify moderator variables.

Table 2
Sharma et al.'s (1981) steps for identifying moderator variables

Step 1	Determine whether a significant interaction is present between the hypothesized moderator variable and the predictor variable by MRA procedure. If a significant interaction is found, then proceed to step 2. Otherwise, go to Step 3.
Step 2	Determine whether the hypothesized variable is related to the criterion variable. If it is, the hypothesized variable is a quasi moderator variable. If not, the hypothesized variable is a pure moderator variable.
Step 3	Determine whether the hypothesized is related to the criterion or predictor variable. If it is related, then it is not a moderator but exogenous, predictor, intervening, antecedent or a suppressor variable. If the hypothesized variable is not related to either the predictor or criterion variable, proceed to step 4.
Step 4	Split the total sample into subgroups on the basis of the hypothesized moderator variable. After segmenting the total sample into subgroups, do a test of significance for difference in predictive validity across subgroups. If significant differences are found, the hypothesized moderator variable is a homologizer variable operating through the error term. If no differences are found, the hypothesized variable is not a moderator variable and the analysis concludes.

Source : Sharma et al. (1981).

RESULTS AND DISCUSSION

The Auditor Industry Specialist

Auditor industry specialist is determined by using portfolio approach proposed by Krishnan (2003b). Table 3 shows the industry specialization among audit firm in Indonesia who affiliated with Big N¹ international audit firm. Audit firm is determined to be industry specialist in industry which the portfolio industry shares exceed the average industry share within audit firm. The coloured areas indicate the industry in which the audit firm became auditor industry specialist. For example, Prasetyo Utomo & Co. is determined to be auditor industry specialist for its clients on basis industry and chemical; consumer goods industry; and trade, service and investment industry during 1999 until 2003.

Industry specialization is determined among audit firms who affiliated with Big N international audit firm since those audit firms dominate the audit services for public listed companies in Indonesia. This condition becomes the reason to focus on clients of Big N affiliated auditors. Moreover, this restriction makes possible to isolate differences due to industry expertise rather than differences in audit quality between Big N auditors and other auditors (Krishnan, 2003b).

There are 211 firm years audited by non-industry specialist and 392 firm years audited by industry specialist. The mean of absolute discretionary accruals is higher for companies audited by non-industry specialists. The auditor industry specialists are more likely to serve larger client as seen on the higher mean value of total assets¹.

Table 3
Auditor Portfolio Share for 1999 until 2003

Industry Classification	Prasetio Utomo & Co.	Prasetyo Sarwoko Sandjaja	HTM	Hanadi Sarwoko Sandjaja	Hadi Sutanto	Siddharta Siddharta Harsono
1. Agriculture	1.20%	0.10%	1.00%		4.20%	
2. Mining	1.10%	1.30%	5.90%	9.00%	14.40%	
3. Basic Industry and chemical	25.80%	25.50%	23.90%	56.10%		
4. Miscellaneous Industry	19.30%	8.00%	33.40%	17.30%	48.60%	7.20%
5. Consumer Goods Industry	22.40%	31.90%	8.90%	4.90%	32.40%	24.10%
6. Property and real estate	1.20%	1.20%	3.90%	0.60%	0.02%	
7. Infrastructure, utilities and transportation	6.60%	8.80%	10.30%	5.20%	2.60%	22.60%
8. Trade, Service and Investment	18.50%	20.20%	12.10%	5.80%	7.80%	
Total Share	100%	100%	100%	100%	100%	100%
Average Share	12.51%	12.5%	12.5%	14.27%	14.3%	33.3%

Source : Processed Data, 2005

Table 4
Auditor Industry Specialization: Comparisons

	Non-Industry Specialist	Industry Specialist
Absolute Discretionary Accruals		
Mean	0.0942304	0.0879016
Std. Deviation	0.10957174	0.09250471
Clients Assets (in million rupiahs)		
Mean	2304920	2443349
N	211	392

¹ Big N refers to the biggest 5 affiliated international accounting firm until 2002 and the biggest 4 affiliated international accounting firm after 2002 (after Arthur Andersen dismissal).

Following Carcello et al. (2004) auditor industry specialization is also measured using continuous measure of portfolio share. The correlation coefficient indicates that auditor industry specialization is not associated with the magnitude of earnings management.

Table 5
Pearson Correlation Coefficients for 1999 - 2003

	SIZE	Spec	DSpec	AbsAccruals	CFO	D Loss	AbsDacc
SIZE	1	-0.050	-0.074	-0.085(*)	-0.003	-.013	-0.152(**)
Spec	-0.050	1	0.748(**)	0.030	0.140(**)	.013	-0.022
DSpec	-0.074	0.748(**)	1	-0.003	0.066	.023	-0.031
AbsAccruals	-0.085(*)	0.030	-0.003	1	-0.068	.366(**)	0.788(**)
CFO	-0.003	0.140(**)	0.066	-0.068	1	-.358(**)	-0.124(**)
D Loss	-0.013	0.013	0.023	0.366(**)	-0.358(**)	1	0.104(*)
AbsDacc	-0.152(**)	-0.022	-0.031	0.788(**)	-0.124(**)	.104(*)	1

* Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

Table 6
The Results of Moderated Regression Analysis¹

Variables	Predicted Sign	Continuous Specification of Industry Specialization		Dichotomous Specification of Industry Specialization	
Dependent :					
AbsDacc		Coefficients	Prob	Coefficients	Prob
Independent :					
Constant		0.001704 (0.754874)	0.4506	0.003939 (1.026732)	0.305
Size	+/-	-0.006408 (-3.873957)	0.0001	-0.006729 (-1.893893)	0.0587
Spec	-	-0.020501 (-1.176772)	0.2398	-0.003668 (-0.772277)	0.4403
Size*Spec	+/-	0.011218 (0.724705)	0.4689		
Size*DSpec	+/-			0.000877 (0.220935)	0.8252
AbsAccr1	none	0.723456 (26.53749)	0.0000	0.723145 (26.47359)	0.0000
CFO	None	-0.129951 (-4.681576)	0.0000	-0.133025 (-4.831673)	0.0000
Dloss	none	-0.058345 (-9.887277)	0.0000	-0.058521 (-9.945098)	0.0000
F-stat		222.812	0.0000	222.0664	0.0000
Adj R Square		0.692		0.691	

Source : Processed Data, 2005

Note : the bracketed numbers equal to t-statistic

The result of the regression is suffering from heteroscedasticity dan colinearity problems. The White's heteroscedasticity-corrected regression is utilized to take into account heteroscedasticity on the computed standard errors and t statistics, therefore the use of t and F test can continue (Gujarati, 1999). Collinearity problem is overcome by centering data. In this case, the value of each variable is subtracted by its mean. Table 6 below shows the regression result.

All of the regressions above indicate the significant negative effect of firm size on the magnitude of earnings management. This finding confirm the monitoring theory that postulates the stronger and sophisticated control built on large firm and hence decrease the possibility of manager to engage aggressive earnings management (Kim et al., 2001). Therefore, the first hypothesis is statistically accepted.

According Sharma's (1981) framework, auditor industry specialization is expected to be a quasi moderator variable in this model. The regression indicates that auditor industry specialization is not a significant predictor for the magnitude of earnings management among public listed companies in Indonesia. However, the negative sign of the relation between auditor industry specialization and the magnitude of earnings management confirms Krishnan's (2003b) finding. Industry specialization by auditors increases the credibility of financial statement by decreasing the magnitude of earnings management.

The interaction terms of the regressions above indicate no significant effect on the magnitude of earnings management. The positive sign indicates that the negative association between firm size and the magnitude of earnings management is getting weaker for firms audited by auditor industry specialist. Auditor industry specialists who better able to detect error and misstatement are not able to strengthen the negative association between firm size and the magnitude of earnings management. This finding indicates two folds. Auditors are emphasizing on client bargaining power due to economic dependent which getting stronger on larger clients. In contrast, Reynolds et al (2001) found that Big N audit firms are emphasizing on reputation cost rather than economic dependent inherent in larger clients. Another explanation related to Kim et al (2001) and Carcello et al. (2004), who suggested that larger clients are likely to be more complex, and hence, more difficult for auditor to possess industry expertise.

Additional Analysis

Recall that auditor industry specialization is not a quasi moderator variable in this study, the fourth step of Sharma's framework is applied by using sub group analysis. The observations are divided into two groups according to the classification of auditor industry specialist. The comparison of R square is applied to judge whether the coefficient regression in each group is significantly different. The results are presented in table 7 below.

The results of sub group analyses indicate that the R squares are not significantly different between those two groups. It means that auditor industry specialization is not able to make difference of earnings management practise regarding the size of the firms. This finding is consistent with the regressions in table 6 above

Table 7
Sub groups analyses

Variables	Industry Specialist	Prob.	Non-Industry Specialist	Prob.
Dependent Variable : Abs Dacc				
Independent Variable :				
Constant	0.2254 (4.982)	0.0000	0.299 (3.012)	0.0029
Size	-0.01 (-3.204)	0.0015	-0.0148 (-2.128)	0.0345
n	392		211	
R Square	0.025		0.024	

Source : Processed Data, 2005, 2005

Note : The bracketed numbers re resent t-statistic

Discussions

H1a is statistically accepted. Firm size negatively affects the magnitude of earnings management which suggested that manager on large firms are less likely to manage earnings. Large firm are more likely to build sophisticated control system. The form of control could be stronger internal control and higher fund to hire prestige independent auditor (e.g. Big N auditor). For the regulators, this finding implies the need to strengthen the control over small firms. But, it should be done without lessening the control over large firms because the possibility of earnings management still exist even the more difficult to detect. For investors, specifically for individual naïve investors, this finding implies that they are better to invest on large sized firms because of the less opportunistic management discretions.

The absolute discretionary accruals are higher on companies served by non-auditor industry specialist rather than the companies served by auditor industry specialist. This finding indicates that the quality of reported earnings on the company audited by industry specialist auditor is higher in terms of the lower level of absolute discretionary accruals and therefore, auditor industry specialization mitigates earnings management (Krishnan, 2003b). However, the negative relation of auditor industry specialization and the magnitude of earnings management is not significant. The manager has considerable discretion to manage reported income within the rules of GAAP (Scott, 2000, pg. 355). Accrual items for managing earnings consist of amortization expense, increase in net accounts receivable, increase in inventory, and decrease in accounts payable and accrual liabilities. Auditor, even if industry specialists, faces difficulty to discover earnings management because the techniques mentioned before are within GAAP.

Auditor industry specialization is not a quasi moderator variable in this study meaning that this variable is not a significant predictor and moderator in the regression. Some international branded-name audit firms had declared themselves about their specialization (Hogan et al, 1999). But the result of this research may create a question whether its affiliation in Indonesia have arranged departments and resources in line of certain industries. This question appears because during the period of observations, industry specialization is not a significant predictor for earnings management even on the restricted observation for companies audited by the affiliation of Big N international audit

firms in Indonesia. This finding implies the need to hold more training according to specific industry by the professional association, and standard setters. It also implies the need to examine the corporate's motives to hire auditor. Regarding this finding, future research should consider the objectives of hiring auditor whether to minimize earnings management or to increase the credibility of financial statement with respect to fulfill regulator requirement.

All of three control variables significantly affect the absolute discretionary accruals. Absolute accruals positively affect the magnitude of earnings management. While, cash flow from operating negatively affects earnings managements. Regarding reported earnings, companies reporting net operating loss decrease its discretionary accruals

CONCLUSIONS AND LIMITATIONS

Findings of this research can be concluded as follows. Firm size negatively affects the magnitude of earnings management (accept H1a). Large firms are assumed to build more sophisticated control system, therefore their managers are less likely to behave opportunistisc. In addition, the absolute discretionary accruals are higher on companies served by non-auditor industry specialist rather than the companies served by auditor industry specialist (Krishnan, 2003b). However, this research failed to find negative relation of auditor industry specialization and the magnitude of earnings management (reject H1b). Auditor industry specialization is not a quasi moderator variable in this study meaning that this variable is not a significant predictor and moderator in the regression (reject H1c).

This research is suffered from the use of proxy for audit quality. A proxy for audit quality is badly needed in investigating audit quality in Indonesia. Future research should consider the latter issues in audit quality research regarding audit tenure (Nagy, 2004), audit opinion, audit fee (Reynolds et al, 2001; Frankel et al., 2002). Future research should use another model in estimating the discretionary accruals component of earnings. One possible model is detecting earnings management through real activity rather than conventional discretionary accruals model. Perhaps, Jones' model (1991) and its modified version (Dechow et al, 1995) are less powerful to detect earnings management in Indonesia because of lack sample compared to the number of sample in the Unites States.

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