


## EARNINGS MANAGEMENT: AN ANALYSIS OF CORPORATE STRATEGY, FINANCIAL PERFORMANCE, AND AUDIT QUALITY



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### ABSTRACT

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This study aims to examine the effect of corporate strategy on earnings management with financial performance and audit quality as moderating variables. This study adopts the concept proposed by Miles and Snow in determining company strategy. The proxies for business strategy are the number of employees to total sales (EMPSAL), the capital expenditure ratio to total assets (CAPTA), and the dividend payout ratio (DPR). Financial performance is proxied by return on assets (ROA), auditor size measures audit quality, and discretionary accruals measure earnings management. The sample was determined using a purposive sampling method, and a sample of 16 companies was obtained with 80 observations. Companies grouped by prospector and defender strategies were analyzed using cluster analysis. Data analysis was carried out using moderated regression analysis (MRA). The results shows that a company's strategy affects earnings management, and that firm performance and auditor quality can moderate the relationship between corporate strategy and earnings management.

**Contribution/Originality:** This study reviews the corporate strategy for earnings management and the differences in the results of previous research. MRA uses financial performance and audit quality, which allows it to be studied from a new perspective.

## 1. INTRODUCTION

The COVID-19 pandemic has forced corporations to adjust their strategies to survive (Handayani, 2021). Sustainability challenges have become a theme in corporate bankruptcy issues, even for large companies, such as energy companies (Ultra Petroleum, Whiting Petroleum, Chesapeake Energy, Diamond Offshore Drilling), aviation and transportation companies (Virgin Australia, Hertz), telecommunications (Frontier Communications, Intelsat), and many retail and other companies (Miller & Berk, 2020). Bankruptcy is unfortunate and distressing and has many implications, e.g., liability to shareholders (Lukason & Camacho-Miñano, 2019), and it affects creditors, employees, suppliers, and many other elements. A company facing bankruptcy may consider obscuring the reality of the situation. This practice is mainly done through earnings management, where management intentionally manipulates or conceals the numbers in the financial statements (Healy & Wahlen, 1999). Earnings management is an effort to engineer the numbers in the financial statements by manipulating the accounting methods and procedures (Chen, Firth, Gao, & Rui, 2006; Chen, Chen, Cheng, & Shevlin, 2010; Healy & Wahlen, 1999; Jamaludin, Sanusi, & Kamaluddin, 2015).

The practice of marking up corporate profits causes a decrease in the quality of the information in a company's financial statements. Contrary to the function of financial statements, namely providing financial information to stakeholders in a transparent and accountable manner (Ghazali, Shafie, & Sanusi, 2015), and the practice of earnings management can have adverse effects (Mahrani & Soewarno, 2018). Earnings management can include increasing current income or reducing current costs. The Toshiba corporation engaged in earnings management in two ways: delaying loss recognition, and hiding prices to regulate cost calculations (Caplan, Dutta, & Marcinko, 2019). This matter went to court, and Toshiba was found guilty in 2015 (Addady, 2015).

Corporate strategy needs to be studied further because of the risk of unhealthy earnings management practices to avoid corporate crises and maintain company performance (Bryan, Fernando, & Tripathy, 2013). A company's performance is reflected in its financial statements (Ahmed, Islam, & Hasan, 2012). The main component of financial statements is profit, which becomes the users' main focus (Ghazali et al., 2015; Noor, Sanusia, Heang, Iskandar, & Isa, 2015; Satya & Amertha, 2013). Business strategies determine a company's success, improve company performance and create a competitive advantage. According to Ward and Peppard (2002), a business strategy is an integrated set of actions to achieve long-term goals and outlines the company's strengths against competitors. Choosing the right strategy will create a superior performance for an organization. Company performance is the result of management's performance and the achievement of company goals. A company's goal is to provide returns on the capital invested by the owners (Tamalee, 2007). A good corporate strategy avoids earnings management practices and motivates in ethical ways (Ahmeti, Ahmeti, & Aliu, 2022; Bentley, Omer, & Sharp, 2013; Houqe, Kerr, & Monem, 2013). Thus, companies must pay attention to earnings quality to improve their performance as part of a business strategy. A company's performance further affects its investment decisions (Francis, Nanda, & Olsson, 2008). This is in line with Tabassum, Kaleem, and Nazir (2013), who stated that corporate strategy involves earnings management for future company performance.

Many other studies on business strategy and earnings management have been carried out (Bentley et al., 2013; Ghofar & Sardar, 2015; Houqe et al., 2013). However, there is an opinion that companies that perform well tend to have higher earnings management (Agustia, Pratama, Muhammad, & Permatasari, 2020; Charitou, Lambertides, & Trigeorgis, 2007; Paul & Rakshit, 2020). This result is different from agency theory, in which managers of poorly performing companies can act opportunistically to increase accounting profits to hide poor performance. On the contrary, companies that perform well have managers who work opportunistically by lowering their accounting profits to delay exemplary implementation (Satya & Amertha, 2013).

The above phenomenon served as motivation for this study to re-examine the empirical evidence related to the effect of business strategy on corporate earnings management. This study uses a moderating analysis technique with variables of financial performance and audit quality to complement our novelty model compared to previous research. Financial performance needs to be reviewed to see the differences in the opinions of previous researchers (Agustia et al., 2020; Charitou et al., 2007; Paul & Rakshit, 2020), while audit quality is an essential part of corporate strategy to deal with ongoing concerns (Paquette & Skender, 1996).

## **2. THEORETICAL FOUNDATION AND DEVELOPMENT HYPOTHESIS**

Managers' responsibilities to stakeholders have the potential to cause conflict and information asymmetry (Jensen & Meckling, 1976; Jensen & Meckling, 2012). Shareholders demand that the company generate high profits and dividends, while managers tend to increase economic and psychological satisfaction (Mahrani & Soewarno, 2018). Thus, the agency relationship is related to the company's strategy (Conelly, Certo, Ireland, & Reutzel, 2011). An agency relationship is a contract that both parties may violate due to differences in interests and information asymmetry. This violation happens when one or both parties are interested in maximizing their own gains. Company managers as agents can use strategies that can harm shareholders, for example, by manipulating the information in financial statements.

Scott (2012) explains that managers choose to include earnings management in their accounting policies to achieve specific goals that can increase the company's market price. According to Sulistyanto and Wibisono (2008), earnings management is used change financial information to enhance company performance to mislead owners or shareholders, or alternatively, to influence contractual results that rely on reported accounting numbers. Walker (2013) identified four conditions that lead to earnings management. Some of these reasons are considered sufficient to provide an opportunity and motivation for managers to carry out earnings management (El Diri, Lambrinouidakis, & Alhadab, 2020). Earnings management cannot be interpreted as solely detrimental because it does not always involve earnings manipulation. In principle, earnings management is a way of presenting earnings information to the public that has been adjusted to benefit the manager himself or benefit the company.

Porter (1980) explains cooperative strategy as a policy that is implemented to overcome problems and beat business competition with a set of values. A company's business strategy outlines how it will conduct business and compete with other companies to achieve and maintain competitiveness in their field Chen and Keung (2019). A company can implement different types of strategy: cost leadership, differentiation, and focus (Porter, 1980). The right strategy is crucial because it outlines how a company should manage its activities, manage different situations, achieve company goals, and implement its earnings management policies. This relationship is widely discussed in the research of Robiansyah, Suranta, Midiastuty, and Saputra (2020) using the type of corporate strategy associated with earnings management. The study results found a relationship between the cost leadership strategy and earnings management. The higher the cost of the leadership strategy, the more earnings management was carried out.

Many parties are involved in making corporate strategic decisions. This involvement triggers particular problems between agents and stakeholders (Jensen & Meckling, 1976; Jensen & Meckling, 2012) because of the information asymmetry problem. It can trigger opportunistic behavior from those who dominate in determining corporate strategy. According to Miles, Snow, Meyer, and Coleman (1978), two different types of individuals, namely prospectors, who are more likely to mitigate an uncertain environment, and defenders, who assume a more stable environment. Referring to Sánchez-Alegría, Lizarraga-Dalloa, and Marín-Vinuesa (2021), the use of quality financial and non-financial indicators is preemptively the key to further business continuity. Shahzad et al. (2022) stated that improving organizational performance is a company strategy to maintain profits in business. Izzati (2017), Wardani and Isabela (2017) and Widyasari, Harindahyani, and Rudiawarni (2017) support the finding that the strategy adopted by a company can influence earnings management actions. Onileowo, Muharam, Ramily, and Khatib (2021) showed that earnings management can be maintained by companies that develop innovation and maintain a competitive advantage.

Financial performance describes the condition of a company. The financial condition of a company reflects its performance in one period. Companies that have clear goals will perform well so the company's financial condition also improves (Gartenberg, Prat, & Serafeim, 2019). Meanwhile, earnings management is an effort by company managers to interpret or influence the information in financial statements to hide any shortcomings from stakeholders.

Financial performance has a role in the association between corporate strategy and corporate earnings management. Corporate strategy can create excellent financial performance which is reflected in the financial statements. In contrast, financial performance can be structured to look good (earnings management). Organizational performance can increase company profits and develop and maintain a good reputation (Fernández-Gómez, Del Castillo, Alaminos, Santos, & Alcoforado, 2019; Huynh, 2018). Therefore, management will employ earnings management to ensure that the financial statements look good. On the other hand, if financial performance is considered good enough, management tends not to develop specific strategies to manage company profits.

The presence of an external auditor who conducts inspections regarding the truth and accuracy of financial statements is essential. The audit process by external parties simultaneously mitigates the risk of impropriety in

financial reporting. It is hoped that it can overcome the problem of delays and fraud among the stakeholders (Omer, Aljaaidi, & Al-Moataz, 2020). Quality audit procedures require careful examination of a company's financial statements, and an unreasonable strategy will arouse the auditor's suspicion leading to a more detailed investigation. Shi, Guo, Xiang, and Zhang (2011) stated that there is a significant relationship between the quality of financial reports and the resulting profits. This means that audit quality can reduce the potential of a company's strategy that refers to the company's earnings management. A quality audit can strengthen performance and affect earnings management (Afsar & Faraj, 2018; Susanto & Widyaswati, 2019). Therefore, large companies with a high level of interest are usually audited by a reputable auditor to reduce the potential for earnings management to occur in subsequent financial statements. The conceptual framework model in this study is shown in Figure 1.

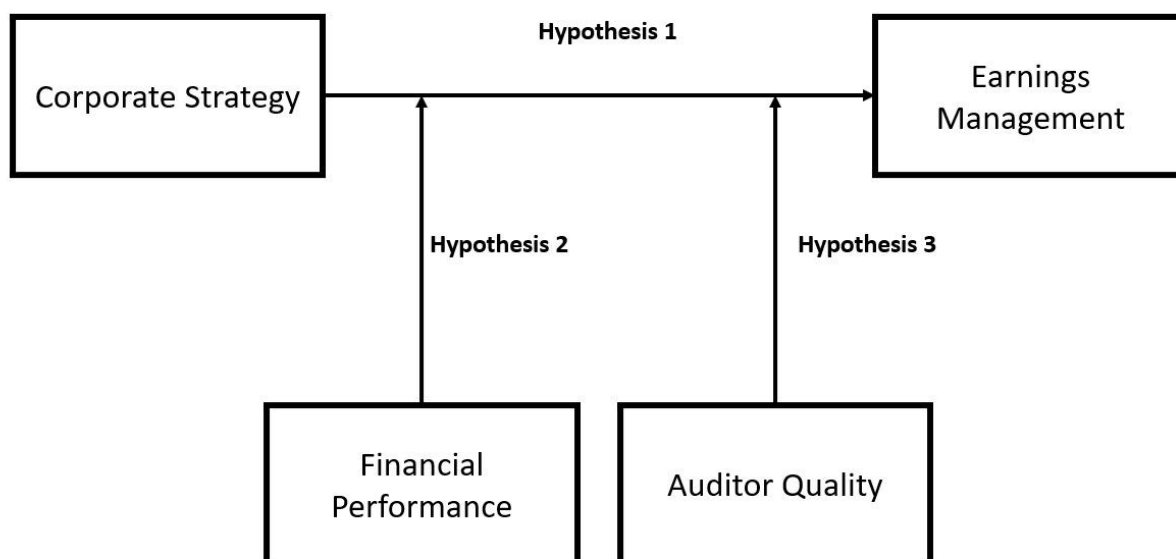


Figure 1. Framework.

Following the objectives of this study, namely testing the effect of corporate strategy on management, and testing the effect of moderating financial performance and audit quality on corporate strategy, the hypotheses of this research are formulated as follows:

*H1: The corporate strategy has a significant positive effect on earnings management.*

*H2: Financial performance can moderate the relationship between corporate strategy and earnings management.*

*H3: Audit quality can moderate the relationship between corporate strategy and earnings management.*

### 3. RESEARCH METHOD

This type of research employed a quantitative method using secondary data from the financial statements of manufacturing companies in the consumer goods industrial sector listed on the Indonesia Stock Exchange from 2015 to 2019. A purposive sampling method was used based on specific criteria according to the research objectives. This study uses one dependent variable (earnings management), one independent variable (corporate strategy), and two moderating variables (company performance and audit quality).

Measurement of corporate strategy refers to Miles et al. (1978), who divided business strategies into four types, *prospector*, *defender*, *analyzer*, and *reactor*, with *prospector* and *defender* being the most powerful strategies. Companies with a *prospector strategy* tend to develop new products and take advantage of market opportunities and always try to develop innovative products. Companies with a *defender strategy* tend to maintain the market that has been achieved with relatively stable products at lower prices through product efficiency. Three proxies are used to determine business strategies and classify companies with *prospector* and *defender strategies*, namely the number of customers

divided by total sales (EMPSAL), capital expenditure divided by total assets (CAPTA), and dividend payout ratio (DPR).

Earnings management is measured using discretionary accruals with the modified Jones approach. The modified Jones model is used because it can provide high statistical power in detecting earnings management (Dechow, Sloan, & Sweeney, 1995). Company performance is based on the ability of management to achieve company goals. The company's goal is to protect the capital invested by the owners. One aspect of company performance can be seen from the company's profitability ratio proxied by the ROA ratio, which is following the research of Ghofar and Sardar (2015). The higher the ROA value, the higher the company's performance because the company's return increases. Audit quality is defined as the market-assessed joint probability that an auditor will discover misstatements in the client's accounting system and report the misstatement. In particular, the probability that the auditor will find an error represents quality in terms of the auditor's knowledge and ability. In contrast, the auditor's likelihood of reporting a mistake measures the auditor's degree of independence.

A previous study on audit quality and its measurement conducted by Al-Khaddash, Al Nawas, and Ramadan (2013) suggested the use of the audit firm's size as a proxy for audit quality. Al-Khaddash et al. (2013) assume that large audit firms tend to perform more rigorous tests and are more likely to be associated with more precise information than smaller audit firms. Following Al-Khaddash et al. (2013), audit quality in this study was measured by auditor size (KAP). Auditor size is measured by a dummy variable, with 1 for companies audited by a Big Four auditor, and 0 for companies not audited by a Big Four auditor. Before testing the hypotheses, the classical assumptions were tested, including normality, multicollinearity, autocorrelation, and heteroscedasticity.

The hypothesis testing interaction was conducted using *moderated regression analysis* (MRA). Moderated regression analysis is used to determine whether there is an influence between the corporate strategy variables on earnings management variables and whether the company's performance variables can moderate the relationship between corporate strategy variables and earnings management. The moderated regression analysis test compares three equations to determine whether company performance can moderate the relationship between business strategy and earnings management.

#### 4. RESULTS

This research uses a *non-hierarchical method*, commonly known as the *K-Means Cluster*. Clusters with above average EMPSAL and CAPTA values and below average DPR values are included in the *prospector strategy group* of companies, and clusters with above average DPR values and below average EMPSAL and CAPTA values enter the *defender strategy group*.

Table 1. Cluster analysis results.

Z-score Variable Value	Cluster	
	1	2
Zscore(EMPSAL)	-0.589	0.684
Zscore(CAPTA)	-0.706	7.677
Zscore(DPR)	1.727	-1.352

Based on Table 1, it can be concluded that the EMPSAL and CAPTA values in *Cluster 1* show a value below the total average, and the DPR value in *Cluster 2* shows a value below the total average.

Table 2. Number of companies per cluster.

Cluster	1	50
	2	30
Valid		80
Missing		0

Based on Table 2, it can be concluded that 50 sample companies fall into Cluster 1, namely companies with a defender strategy, and 30 sample companies enter Cluster 2, namely companies with a prospector strategy. Companies with a defender strategy are given a weight of 1, and companies with a prospector strategy are given a weight of 0.

Table 3. Moderated regression analysis (MRA) test.

Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.082	0.050	-	-0.824	0.414
	CS	0.005	0.049	0.007	0.100	0.921
	FP	0.798	0.229	0.284	3.490	0.001***
	AQ	-0.020	0.026	-0.082	-0.750	0.455
	MOD1	-5.810	0.374	-0.985	-15.541	0.000***
	MOD2	0.134	0.037	0.576	3.613	0.001***

Notes: CS = Corporate Strategy; FP = Financial Performance; AQ = Audit Quality; Mod1 = Moderated Regression Analysis 1; Mod2 = Moderated Regression Analysis 2; \*\*\* denotes significance at  $\alpha$  0.001.

The regression equations obtained from the test results are shown in Table 3.

$$Y = -0.082 + 0.005X_1 + 0.798 Z_1 - 0.020 Z_2 - 5.810 (X_1 * Z_1) + 0.134 (X_1 * Z_2) + e$$

$$EM = -0.082 + 0.005 CS + 0.798 FP + 0.020 AQ - 5.810 (CS * FP) + 0.134 (CS * AQ) + e$$

Notes:

EM = Earnings Management.

CS = Corporate Strategy.

FP = Financial Performance.

AQ = Audit Quality.

MOD1 = Moderation 1: The interaction between corporate strategy and financial performance.

MOD2 = Moderation 2: The interaction between corporate strategy and audit quality.

Table 4. First hypothesis testing results.

$$EM = \alpha + \beta_1 CS + \epsilon_{it}$$

Model Analysis	Prediction	Coefficient	t-statistic	p-value	Decision
CS	(+)/(-)	0.152	7.208	0.000***	
Adjusted R <sup>2</sup>	39.9				
F-Stats	51.949				
Sig. F	0.000				
Observations	80				

Note: \*\*\* denotes significance at  $\alpha$  0.001.

Table 5. Second hypothesis testing results.

$$EM = \alpha + \beta_1 CS + \beta_2 ROA + \beta_3 MOD1 + \epsilon_{it}$$

Model Analysis	Prediction	Coefficient	t-statistic	Significance	Decision
C	(+)	0.058	4.294	0.000	Supported
CS	(+)/(-)	0.123	6.916	0.000***	
ROA	(+)/(-)	0.173	3.490	0.001***	
MOD1	(+)/(-)	-5.810	-15.541	0.000***	
Adjusted R <sup>2</sup>	61.4				
F-Stats	42.886				
Sig. F	0.000				
Observations	80				

Note: \*\*\* denotes significance at  $\alpha$  0.001.



Table 4 shows that the corporate strategy variable obtains a regression coefficient of 0.152 and a p-value of 0.000 (very significant). Thus, it can conclude that corporate strategy affects earnings management. So, the first hypothesis, which states that corporate strategy involves earnings management, is accepted. The results of testing the second hypothesis can be seen in Table 5.

Based on Table 5, it can see that the regression coefficient of the MOD1 variable, which is the interaction between corporate strategy and company performance, is -5.810, and the -t-count is more significant than the -t-table ( $-15.541 < -2.0095$ ) with a significance value of ( $0.000 < 0.05$ ). Thus, it can be concluded that there is an interaction between corporate strategy and financial performance on earnings management. So, the second hypothesis, which states that company performance can moderate the relationship between business strategy and earnings management, is accepted.

Table 6. Hypothesis testing results (Defender strategy).

$$EM = \alpha + \beta_1 CS + \beta_2 AQ + \beta_3 MOD2 + \epsilon_{it}$$

Model Analysis	Prediction	Coefficient	t-statistic	Significance	Decision
C	(+)	0.052	2.858	0.005	Supported
CS	(+)/(-)	0.052	1.686	0.096*	
AQ	(+)/(-)	0.006	0.190	0.850	
MOD2	(+)/(-)	0.126	2.991	0.004***	
Adjusted R <sup>2</sup>	51.9				
F-Stats	29.363				
Sig. F	0.000				
Observations	80				

Note: \*\*\* denotes significance at  $\alpha$  0.001, \* denotes significance at  $\alpha$ , 0.01.

Based on Table 6, it can see that the regression coefficient of the MOD2 variable, which is the interaction between corporate strategy and audit quality for companies with the defender strategy, is 0.126. The t-count value is greater than the -t-table ( $2.991 > -2.0095$ ) with a significance value of ( $0.004 < 0.05$ ).

Table 7. Hypothesis testing results (Prospector strategy).

$$EM = \alpha + \beta_1 CS + \beta_2 QA + \beta_3 MOD2 + \epsilon_{it}$$

Model Analysis	Prediction	Coefficient	t-statistic	Significance	Decision
C	(+)	0.104	4.219	0.000	Supported
CS	(+)/(-)	-0.052	-1.686	0.096*	
QA	(+)/(-)	0.132	4.739	0.000***	
MOD2	(+)/(-)	-0.126	-2.991	0.004***	
Adjusted R <sup>2</sup>	46.9				
F-Stats	35.868				
Sig. F	0.000				
Observations	80				

Note: \*\*\* denotes significance at  $\alpha$  0.001, \* denotes significance at  $\alpha$ , 0.01.

From Table 7, it can be seen that the regression coefficient of the MOD2 variable, which is the interaction between corporate strategy and audit quality for companies with the prospector strategy, is -0.126. The -t-count value is smaller than the -t-table ( $-2.991 < -2.0095$ ) with a p-value of ( $0.004 < 0.05$ ). Thus, it can be concluded that there is an effect of the interaction variables of corporate strategy and audit quality on earnings management. So, the third hypothesis, which states that audit quality can moderate the relationship between business strategy and earnings management, is accepted.

## 5. DISCUSSION

The results of testing the first hypothesis indicate that the corporate strategy chosen by a company is a factor that encourages earnings management. Companies that use the defender strategy seek to locate and manage a secure market with relatively low-cost products. According to Houque, Kerr, and Monem (2013), companies with a defender strategy have the motivation to maintain their reputation as a stable company, which tends to meet investors' expectations by carrying out earnings management. Meanwhile, companies using the prospector strategy are not under pressure to seek new market opportunities by emphasizing innovation. Furthermore, Houque et al. (2013) concluded that companies with a defender strategy use more earnings management because it has more investors who have seen the company in a mature or stable environment. The company's performance must show its superiority and stability from period to period.

The results of this study support the research of Januarsi, Badina, and Febrianti (2014); Houque et al. (2013); Izzati (2017); Wardani and Isabela (2017) and Widyasari et al. (2017), who found empirical evidence that the corporate strategy chosen by a company affects its tendency to carry out earnings management.

The results of testing the second hypothesis indicate that in companies that choose a defender strategy, the higher the profitability achieved, the lower the tendency to carry out earnings management. Companies with high corporate performance will also continue to improve their ability to pay debts so that they can borrow more, and creditors will continue to believe in the company. Companies may accrue debt to fund their operational activities, and high-performing companies tend to carry out earnings management so that their profits are in line with the expected earnings. In contrast, a company with a low performance will be motivated to manipulate its earnings to make it look good.

The results of testing the third hypothesis indicate that for companies that choose a defender strategy, the higher the audit quality, the greater the tendency to carry out earnings management. In companies with a defender strategy, audit quality does not reduce earnings management. Companies with a strong defender business strategy perform higher earnings management than companies with a prospector strategy.

Different results were obtained for companies that chose the prospector strategy. The negative regression coefficient indicates that audit quality can weaken the relationship between corporate strategy and earnings management. It suggests that the higher the audit quality of the company, the lower the tendency to carry out earnings management. The research results found by Inaam, Khmoussi, and Fatma (2012) and Alzoubi (2018) show that quality audits can reduce the level of earnings management carried out by the client. Good audit quality can reduce the tendency to carry out earnings management in companies classified as *defenders*.

## 6. CONCLUSION

This study aims to examine the effect of corporate strategy on earnings management. Empirical results show that the corporate strategy chosen by a company influences its use of earnings management. This study also provides empirical evidence that financial performance can weaken the relationship between corporate strategy and earnings management, measured by the return on assets ratio. This finding has a theoretical contribution that for companies that choose the defender strategy, the higher the profitability achieved, the lower the tendency to carry out earnings management. This study also proves that the higher the quality of the auditor hired by the company with a prospector strategy, the lower the company's tendency to carry out earnings management, but companies with a defender strategy show the opposite result.

This study has limitations that may affect the results: 1) This study is limited to manufacturing companies in the consumer goods industry sector, so it cannot be generalized to all companies in Indonesia; 2) only two of the four corporate strategies were tested (prospector and defender); 3) the measurement of earnings management using accruals does not test real earnings management.



Further research can expand the sample to all manufacturing companies, test the two other corporate strategies, and use a real earnings management approach so that the results are more valid and comprehensive.

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