THE EFFECT OF LITIGATION RISK AND AUDIT QUALITY ON EARNING MANAGEMENT: EVIDENCE IN INDONESIA

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Abstract: - In agency theory, entities that separate management and ownership functions will become vulnerable to agency conflicts. Agency conflicts that arise cause information provided by managers to be different or can be manipulated. One common practice carried out by managers is earnings management, where earnings management is a choice of accounting policies carried out by managers for various specific purposes. This research aims to examine and analyze the effect of litigation risk on earnings management and whether audit quality moderates the relationship litigation risk on earnings management. Warp PLS version 5.0 is used as a data processing tool. The object of this research is food and beverage companies that are listed on the Indonesia Stock Exchange period 2013-2017. The test results prove that litigation risk affects earnings management and audit quality strengthens the influence of litigation risk on earnings management.

Key-Words: - Litigation Risk, Audit Quality and Earning Management

1 Introduction

The violation committed by Halliburton related to the petroleum business with the Angolan BUMN entity named SONANGOL occurred in Indonesia. The petroleum business was considered corrupt as a result of which Halliburton was liable to a fine of US $ 29.2 million. This is based on the rules in the Foreign Corrupt Practices Act (FCPA). In addition, Halliburton is required to comply with anti-corruption policies for a minimum of 18 months. Halliburton's vice president named Jeannot Lorenz, was also fined USD75,000 for falsifying accounting books or commonly called earnings management. Healy and Wahlen (1999) states that earning management occurs if several stakeholders are experienced by managers regarding economic performance of the entity. Directives in preparing transactions to become financial statements are used by managers to falsify the magnitude of accounting numbers to several stakeholders about the performance of the entity even as an effect on the contract results that depend on reported earnings.

Information that is the focus of users of financial statements is about earning (Beattie et al., 1994). Earning is used as the basis for determining the increase in stock prices and management performance measurement during the period. This is what encourages the occurrence of managerial deviation behavior in preparing financial statements to look good in the eyes of users of financial statements. Management has the power to determine what information will be reported even for its own purposes. The absence of effective controls and disciplinary action by stakeholders on financial statements can lead to management actions that do not provide actual information. Earnings management is carried out by management to take advantage of opportunities. The control can be carried out by an external auditor. The role of external auditors is to convey material misstatements and asymmetric information between entity management and stakeholders on financial statements, including earnings management.

The external auditor as an internal party that does not take sides between management and stakeholders, should have a commendable quality auditor to be able to convey material misstatements in the financial statements. Recent cases of audit failures have cast doubt on the auditor quality regarding his competence. Interested parties such as: CEO, Commissioner, Audit Committee, even internal and external auditors in leading entities such as Enron, Worldcom, and Xerox also experienced audit failures. The audit quality of an auditor is questioned when the public accounting profession is criticized. This causes investors to question the auditor's ability to uncover earnings management.

De Angelo (1981) explains that audit quality is measured from where the accountant's office came from. A large accounting firm is believed to be able to produce quality public accountants because they are provided with training and investment in audit technology. Competence and independence are some things that can affect audit quality (Christiawan, 2002). Competence includes the level of education achieved and adequate knowledge possessed by a public accountant in accounting and auditing expertise. Another important role is a quality audit report also determines the value of the quality of the public accountant.

The problem of earnings management practices should be detected by qualified auditors (De Angelo, 1981). This statement is reinforced by the explanation of Palmrose (2004) that audit quality is made as a possibility if the financial statements avoid material misstatements. If there are parties outside the entity who feel aggrieved over the information in the financial statements, the party can make a claim against the auditor. This is commonly called litigation risk (Ahmad, 2009). The demand can be a high fine. Generally in Indonesia the law has different laws in Western countries. Likewise with the research conducted, if in Indonesia using the encouragement of qualified accountants is the same as the Big Four KAP auditors, while in the US and Europe the financial statements audited by the Big Eight KAP are good financial statements. The fact is that in Indonesia the risk of litigation against auditors is lower compared to the United States (Dahlan, 2009).

Non-compliance or violation of laws is the cause of auditors dealing with lawsuits. Examples of Halliburton cases related to businesses that are considered corrupt and manipulating bookkeeping can be exposed to FCPA. Another reason why the auditor is confronted with lawsuits is because he is an easy target for compensation claims. Especially the network of global and international accounting offices or Professional Indemnity Insurance (PII). The degree of conformity with different audit standards between Public Accountants of different sizes is mentioned by the Report on the Observance of Standards and Codes (RSOC). Small KAP is usually more difficult to implement quality control due to limited resources. KAP which is considered to meet international standards is a large KAP that cooperates with the Big Four. RSOC 2010 related to the contents of the interview with the Center for Accounting and Appraisal Services (PPAJP) at the Ministry of Finance PPAJP found that from existing KAPs (more than 400), only a few were able to meet good audit standards. Unlike the beliefs in the United States that obey the law. This country considers demand-suing is culture. Law abiding communities to solve problems between them.

Atiqah & Purwanto (2011) and Kirana & Hardi (2016) both show that litigation risk has no influence on earnings management. In contrast, Kartika and Nahumury (2014) research explains that litigation risk has an influence on earnings management with a significant level of 0.02. Litigation risk has a negative influence on earnings management (Sari, 2015). This means that if the high level of risk of litigation will reduce the occurrence of earnings management. From the research above all shows that audit quality can moderate the influence between litigation risk and earnings management. But not with Kartika and Nahumury (2014) research which states that quality audits cannot strengthen the relationship between litigation risk and earnings management. The explanation above shows that the results of the research are still not consistent, therefore this theme is still interesting to review. So that the research question proposed is 1) whether litigation risk affects earnings management? 2) does audit quality moderate the effect of litigation risk on earnings management?.

2 Problem Formulation

2.1 Litigation Risk on Earning Management

The litigation risk is defined as risks inherent in the company which makes it possible threat of litigation by the parties have an interest in the company who feels disadvantaged. The parties who are interested in the company include creditors, investors and regulator. The risk of litigation can be measured from various financial indicators be a determinant of possibility litigation (Juanda, 2007). Litigation risk can arise from the parties creditors and investors. From the side creditor, litigation can arise because of company does not run its operation is in accordance with that contract agreed. For example inability of companies to pay debts that have been given creditor. Risk of litigation originating from creditors can be obtained from indicator of risk of disability company in paying debt short and long term. In terms of investors, litigation can arise because the company is running operation that will result in loss for the investor. Low litigation risk makes managers easy to do irregularities in presenting financial statements so that it will reduce quality of financial statements and complicate investment activities (Chung et al,. 2013).

According to Namazi (2013) and Balago (2014) agency relationship results in problems such as asymmetry information, management generally has more information about the actual financial position and position operating entity rather than owner. Based on agency theory explained earlier that the principal wants a maximum financial return while the agent has other desires. The agent's desire is to make the value of the entity look good in the eyes of stakeholders. This causes the agent to do a game of earnings management. Even though the game triggered lawsuits from stakeholders who felt aggrieved over incorrect information. This demand more often affects auditors. According to Juanda (2009) litigation risk can be interpreted as lawsuits from individuals or groups that are related and feel disadvantaged to the entity, this risk is very close to the entity and becomes an opportunity for the threat of litigation. These individuals or groups include creditors, investors, and regulators. Policies that are made more selective on investor protection, the quality of earnings will be higher. The policy is the risk of litigation. Higher litigation risk will lead to lower earnings management practices (Francis, 2006). Litigation risk deals with legal issues, this will incur significant costs. The failure of the interests of investors and creditors is the trigger for litigation or legal demands. A high level of earning will result in the higher risk of litigation, logically the agent will avoid losses caused by the litigation through conservative financial reporting. The Parastoo Research (2016) found that the quality of reports high finance makes the company's investment activities efficient. Decreasing information asymmetry indicates disclosure of information good and this can make the company's investment more efficient.

The risk of litigation can provide benefits to public companies because of the difficulties inherent in the company and its advisors has accurately and completely conveyed the relationships among the beneficiaries of the company (Heminway, 2016). Shareholder litigation can be a monitoring tool for external parties that is quite effective for short-term investors who function as a substitute for the company's internal governance mechanism Pukthuanthong et al., 2017). One potential monitoring mechanism is shareholder litigation. Litigation risk will affect disclosure choice by disciplining the company's voluntary disclosure behavior and reducing manager's incentives for provide misleading information (Cazier et al., 2017). Measures of litigation risk inherent in the company will be able to influence encouraging behavior or managers (Skinner, 1997), Juanda (2009) states that the risk of litigation affects the entity to voluntarily deliver the initial bad news information. This is also supported by Brown et al. (2004) who studied the effects of litigation risk on earnings management, found that litigation risk has a positive effect associated with the possibility of disclosing earnings management related to bad news. Sari (2015) shows that litigation risk affects earnings management. From the above argument, the first hypothesis can be generated.

H1: Litigation risk affects earnings management.

2.2 Audit Quality Moderates the Effects of Litigation Risk on Earning Management

The emergence of earnings management practices can explain by agency theory. In theory agency assumes that agents have more a lot of information than the principal, because of the principal unable to observe the activities carried out agent continuously. In condition this asymmetry needs a third person namely the auditor as a party deemed capable bridging the interests of the principal (shareholder) and the manager (agent) in managing company finance. Ardiati (2005) mentions that audit is of high quality acts as a deterrent effective earnings management, because of reputation management will be destroyed and the value of the company will drop if this wrong reporting detected and revealed. Internal audit quality this study was measured by the size of KAP, BIG Four and Non BIG Four and the industry specialization of auditors. Meutia (2004) and Herusetya (2009) found that the higher the quality audit using KAP size (The KAP Big-4) the lower earnings management happened at the company. Besides at Indonesia, research Rusmin (2010) throughout non-financial company in Singapore year 2003 and the research of Gerayli et al. (2011) throughout non-financial companies in Iran in 2004 too found the size of KAP was negatively related with earnings management.

Assessing quality audits is often the Big Four and non-Big Four are used as benchmark measures. The study conducted by De Angelo (1981) concluded that auditor quality as an auditor's freedom in obtaining irregularities in financial statements. Among other things, the ability, knowledge and experience of an auditor from a large accountant office is seen that audit performance has advantages compared to a smaller accounting firm is a component that affects the findings of irregularities that occur in financial statements. According to Payamta's (2006), the Big Four are considered to have superior audit quality levels compared to non-Big Four KAPs. The Big Four's knowledge, expertise and independence are considered superior to other KAPs. This is so that auditors avoid litigation risk. Audit reports contain the relevance of three circles, among others: (1) entity investors, (2) audited entity managers, (3) and third parties. The auditor gets pressure from the three groups to continue to convey any form of information that might contain irregularities. It can take the form of lawsuits or commonly referred to as litigation (Goldman and Barlev, 1994).

The KAP of the Big Four who audited the entity assessed that the quality of their earning will increase if the risk of litigation is low. So that conclusions can be drawn because good quality of earnings can be viewed from the existence of manager's actions for personal interests by increasing or decreasing the earning, earnings management can be influenced by the risk of litigation. Increasingly selective policies lead to higher quality of earnings or audit quality, the risk of litigation obtained by the entity will be lower. If there is good audit quality and litigation risk, it can be estimated that the entity's earning manipulation in earnings management practices will be lower. The second hypothesis is as follows.

H2: Audit quality can moderate the effect of litigation risk on earnings management.

3 Problem Solution

Food and baverage entities registered on the Indonesia Stock Exchange in 2013-2017 more and more are going public, so it is interesting to become a population in this research. The purposive sampling method was used in data collection, the sample used was a food and baverage entity on the IDX with the following conditions: 1) Food and baverage entities registered on the IDX during the period 2013-2017, 2) Entities that did not make transfers sector of the food and baverage sector in 2013-2017, 3) Having data that did not carry out delisting in 2013-2017. Data regarding these financial statements are from the Indonesia Stock Exchange in 2018. Warp PLS version 5.0 is used as a data processing tool whose results are analyzed.

The research variables used in this research are litigation risk as an independent variable, earnings management as the dependent variable and audit quality as a moderating variable. Concept definitions and operational definitions of each variable are explained the following. The risk of litigation can be interpreted as lawsuits carried out by the parties concerned who feel disadvantaged by the entity. This risk is very close to the entity that allows the risk of litigation (Juanda, 2009). Creditors, investors, and regulators are individuals or groups concerned with the entity. Determining opportunities for litigation can be measured from various financial indices. This can arise because the company does not operate according to the agreed contract. For example, the inability of companies to pay debts that have been given by creditors. The risk of litigation originating from creditors can be obtained from indicators of the risk of the company's inability to pay short and long-term debt. In terms of investors, litigation can arise because the company carries out an operation which will result in losses for investors, as reflected in the price and volume movements of the shares. For example, hide some negative information that should be reported.

The variables that determine X are volatility, financing and leverage and the size of the entity as follows:

1. Beta Shares (Tandelilin : 2010)

$$RET_{it} = \alpha + \beta RM_{it} \tag{1}$$

RETit : entity stock return i in period t
α : intercept or risk free return
β : beta of entity shares i in period t
RMit : market return in period t

2. Stock Turnover (Ahmad : 2009)

$$TURNOV_{it} = \text{Average } VOL_{it} / LBSh_{it} \tag{2}$$

TURNOVit : turnover or stock volume turnover
Average VOL_{it} : average volume of shares
LBShit : number of shares outstanding

3. Likuidtas (Subramanyam, Jhon et al.,2008):

$$LIK_{it} = \text{short-term debt / current assets} \tag{3}$$

LIKit : entitlement liquidity during period t

4. Leverage (Subramanyam, Jhon et al., 2008)

$$LEV_{it} = \text{long-term debt / total assets} \tag{4}$$

LEVit : entitlement leverage during period t

5. Size of entity (UKR) (Ahmad : 2009)

$$UKR_{it} = \text{LogNatural total assets} \tag{5}$$

UKRit : size of entitlement during period t

To determine the risk index litigation using the sum of the five variables. The high level of index value determines the high X too, and vice versa if the index value is low. To calculate earnings management, the Modified Jones Model formula is used, because this model is considered the best in calculating earnings management. The current period accrual is the result of the transition when the entity's economic scope associated with the sales transition, then all variables used will be shared with the assets of the past period are the basis of the use of this Jones model. Following is the calculation model:

1. Total Accrual entities are calculated as follows:

$$TA_{it} = N_{it} - CFO_{it} \tag{6}$$

TAit : Total Accrual entity i in period t
Nit : entity net profit I in the t-period
CFO¬it : Cash flow from change activity in period t

2. The total accrual value estimated by the OLS regression equation as follows:

$$TA_{it}/A_{it-1}=\beta_1(1/A_{it-1})+\beta_2(\Delta Sales_{it}-\Delta Rec_{it}/A_{it-1})+\beta_3(PPEt/A_{it-1})+e \quad (7)$$

TAit : Total Accruals of entity i in period t
Ait-1 : Total entity assets i in period t (before)
ΔRecit : Change in entity receivable i in period t
PPEit : Value of fixed assets of entity i in period t
e : error

3. From the regression equation above, ND can be calculated by the formula:

$$NDA_{it}=\beta_1(1/A_{it1})+\beta_2(\Delta Sales_{it}\Delta Rec_{it}/A_{it1})+\beta_3(PPEt/A_{it-1})+e \quad (8)$$

NDAit : Non Discretionary Accruality i in period t
Ait-1 : Total Asset an entity I in period t
ALSALESit: Difference in salesability i in period t
ΔRecit : Change in entity's receivables in period t
PPEt : Value of fixed assets of entity i in period t

4. Furthermore DA can be calculated as follows:

$$DA_{it} = (TA_{it}/A_{it-1}) - NDA \quad (9)$$

DAit : Discretionary Accruality i in period t
TAit : Total Accruals of entities i in period t
Ait-1 : Total Asset an entity I in period t
NDAit : Non Discretionary Accruality i in period t

Audit quality is all possibilities where the auditor when auditing the client's financial statements can find violations that occur in the client's accounting system and report them in audited financial statements, where in carrying out their duties the auditor is guided by the auditing standards and relevant public accountant's code of ethics. The value for the entity audited by the auditor from the KAP Big Four is one, while the one audited by non-Big Four is zero, dummy is the variable used to measure this variable. The following is a Table 2. that presents research findings using Warp PLS version 5.0.

Table 1. Sample Selection

Information	Total
Food and beverage entities listed on the IDX in 2013-2017	16
Food and beverage entity that moves the sector in 2013-2017	(1)
Food and beverage entities delisted in 2013-2017	(1)
Entities selected are sampled	14
	Number of observations
Year 2013-2017 (14 Food and Beverage Entities x 5 Years)	**70**

Souce : Indonesia Stock Exchange, 2018

Table 2. Hypothesis Testing Results: Mediator Effect

Path	Direct Effect		Indirect Effect		Remark
	Coefficient	p-value	Coefficient	p-value	
LITIGATION → Eearning Management	0,310	<0,010			H1 Accepted
LITIGATION → Audit Quality → Earning Management	0,250	0,010			H2 Accepted
Indikator Model Fit					
Average Path Coefficient (APC)	0,277	0,003			
Average R-square (ARS)	0,249	0,007			
Average Variance Inflation Factor (AVIF)	1,613				

Source: WarpPLS Processed products (2018)

3.2 Result and Discussion

Food and baverages companies listed on the IDX are used as research samples. Based on the predetermined sample criteria, it was obtained a sample of 14 entities registered on the Stock Exchange from 2013-2017, so that the observation data of 70 were obtained. The essence of the sampling process can be seen in Table 1.

3.2.1 Litigation Risk on Earning Management

Table 2 shows that a significance value of <0.010 with a positive beta value of 0.310 means that the first hypothesis is accepted. This means that litigation risk has a positive effect on earnings management. The results of this research are consistent with the research conducted by Brown et al. (2004); Mohammadi and Amini (2016) who studied the effects of litigation risk on earnings management, found that litigation risk has a positive effect associated with the possibility of disclosing earnings management related to bad news. In line with Brown et al. (2004); Kartika and Nahumury (2014) also found the same evidence, that the risk of litigation has an effect on earnings management. However, this research is not in line with Atiqah and Purwanto (2011) which states that litigation risk has no influence on earnings management.

The form of corporate management accountability to investors is by reporting the company's financial statements. These financial statements are used by shareholders and prospective investors to make investment decisions in the future. Therefore, it is fitting that the financial statements presented by management reflect the actual financial condition of the company. Information that is not aligned or information asymmetry that occurs between management and the owner of the company can lead to fraud committed by the company manager. Based on certain interests, managers carry out earnings management. Non-aligned information obtained between management and external parties can be overcome by conducting an audit process. The auditor is expected to be able to detect and find errors in the financial statements so that the report does not mislead investors. Even though it has been through an audit process, errors in financial statements may still occur. If the auditor makes a mistake in the audit process, the auditor risks getting lawsuits from third parties. The risk of getting lawsuits from third parties who feel disadvantaged is called risk litigation (Juanda, 2008). Quality in auditing is also considered to have an important role in producing quality audit reports. De Angelo (1981) defines auditor quality as a possibility where it will find and report violations contained in the client's accounting system Litigation risks faced by auditors, especially in environments that have strict legal protection regulations for investors will increasingly high. Therefore, the auditor's credibility in detecting fraud and errors in financial reporting is highly tested. The better audit quality will be able to improve the quality of earnings from financial statements.

Litigation risk is a risk of getting lawsuits from external parties who use financial statements to make decisions because these parties feel disadvantaged (Juanda, 2007). Heninger (2001) and Palmrose and Scholz (2004) revealed that auditor litigation depends on the amount of earnings management. Heninger (2001) further explained that high earnings management would encourage the high impact of litigation on auditors. Auditors relate to the amount of discretionary accruals in auditor litigation risk assessment. Litigation risk is a risk that deals with legal issues so that it has the potential to incur significant costs. Agency theory explains that it is very possible for managers to report finance by earning management, because the higher the earning, the higher the ability of litigation risk. Generally, the entity will choose to provide financial statements in accordance with the events that occur. The entity should also have an auditor who checks financial statements to avoid litigation risk caused by earnings management.

3.2.2 Audit Quality Moderates the Effects of Litigation Risk on Earning Management

Based on the information presented in table 2 shows that audit quality moderates the effect of litigation risk on earnings management. This is evidenced by the significance value presented in table 2, which shows 0.010 with a positive beta value of 0.250. The significance value is below 0.050 meaning that this test is able to prove the hypothesis is accepted. The results of this research are in line with Sari (2015) which states that audit quality strengthens the influence of litigation risk and earnings management. It means that the better audit quality presented by public accountants will strengthen the influence of litigation risk on earnings management. This is in accordance with agency theory which states that there are differences in interests between principals and agents. The manager will provide the report as it is if the earning obtained by the company are high because the higher the earning the company receives, the higher the risk of litigation ability. Audit efforts are almost as important as the costs of reducing the risk of litigation (Bronson, 2017). Now, there has been a considerable increase in various litigation activities, most of the lawsuits are unconditional, namely the plaintiff trying to recover investment losses from companies that prefer to settle rather than face large and risky costs associated with the trial (Walker et al., 2015).

According to some previous studies Payamta (2006), big auditors have better audit quality than non-big auditors. Knowledge, skills, and independence of Big 4 are considered better than other KAP. Risk litigation occurs when there is a deviation or mismatch over the agreement that the company has made with third parties that can damage the name company. Prevention of litigation risk can be done through improvements audit quality. Foerster et al., (2016) mention cash flows in the future the front can be predicted through current profits. Financial information describe the condition of the company that will actually be easy to use in planning capital allocation activities in the future. Meutia (2004) found that audit quality is related to earnings management. The higher the quality of the audit carried out, the lower the earning management that occurs in a company. Francis and Wang (2006) revealed that the quality of earnings will increase or higher when the risk of litigation is high for companies audited by the big auditor. This means that earnings management will go down to high litigation risk and be audited using the services of the big auditor.

4 Conclusion

Audit quality that is proxied by specialization auditor industry has a negative effect towards earnings management, these results support Gerayli et al., (2011); Gramling et al., (2001). This is because industry specialization auditors have knowledge superior knowledge about industry certain. Industrial auditor's specialization ability to detect management earnings will push client not to do earning management so that the quality of earnings increases. other than that Industrial specialization auditors can also detect earnings management to maintain reputation they are auditors.

At the risk of litigation high with the use of Big 4 audit services or good quality audits will be able to make earnings management tends to be lower. The results of this study are in line with research by Francis and Wang (2006) argue that the company is audited by Big 4 and have a litigation risk high will be able to produce high quality of earnings. Quality of earnings the high can be seen with the low the company's earnings management, because good audit quality can be seen from low or no earnings manipulation at in financial statements. High litigation risk with good audit quality by using Big auditor services make earnings management become lower because it corresponds to previous studies (Meutia, 2004; Dahlan, 2009; Indriani, 2010) who states that the big auditor can make earnings management is lower. Based on the research that has been done, then conclusions can be made as follows: 1) the risk of litigation has an effect on earnings management, 2) audit quality strengthens the effect of litigation risk on earnings management.

The limitations of this study include measurement of earnings management variables only focuses on accrual earnings management only For future research, it should be consider the element of real earnings management (Rahman and Hutagaol 2008; Lestari and Herusetya 2013). Besides quality measuremen the audit in this study only uses KAP size and industry auditor specialization. In the next study can use audit assignment period and independence as measure of audit quality (DeAngelo 1981 and Lestari and Herusetya 2013).

Based on the results of this study, it can be suggested for investors before taking investment decisions in a company to prefer a company that is use industry auditor specialization because with the existence of industry specialization auditors can limit the practice of earnings management that occurs in a company. The limitations of this study are: this study only focuses on food and beverage companies so that the results cannot be generalized. So the suggestion for the next research agenda is to use broader research objects so that the results can be generalized. In future research expected to add several variables others that can better explain the factors which can affect earning management. Future research is also expected to be able to use continuous data inside calculate litigation scores for information optimal related litigation.

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