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Audit Quality and Real Earnings Management: An Analysis Based on the Auditor Industry Specialization and Client Importance

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Abstract

Real earnings management reflects management intervention to manipulate earnings based on the company's normal business activities. This intervention is veiled and difficult to detect so it requires specialist auditors who expertise in industrial business practices. In the agency theory, the quality auditors representing external governance serves to reduce asymmetric information between management and shareholders and minimize agency costs. Auditor quality is determined by the auditor's ability and independence to detect abnormal business practices. Industry specialization auditors have the competence, expertise, and skills to find out whether or not there are abnormal business practices for the purpose of earnings manipulation. Meanwhile, client importance that reflects the level of economic dependence of the auditor on the client encourages the auditor to be ignorant or tolerant of manipulation of business activities for the purpose of management opportunism. This research was conducted on manufacturing and trading companies listed on the Indonesia Stock Exchange in the 2012-2016 period. Observation is carried out on 430 data

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and analysis by multiple linear regression. The test results prove that the auditors of industrial specialization have a negative effect on real earnings management. Client importance also proved to have a positive effect on real earnings management.

Keywords: Real Earnings Management, Auditor Industry Specialization, Client Importance

Introduction

This study aims to examine auditor competence and independence which is reflected in the auditor's industry specialization and the client importance in detecting real earnings management through business activities. Accounting scandal of large companies audited by reputable public accountants reduces investor confidence in financial statements, decreases investor confidence in financial statements because the company does earnings management. Real earnings manipulation research is important to do because it directly affects business decisions and cash flow so that it is more dangerous for companies than accrual earnings management (Barton and Simko 2002), gets less attention from auditors (Cohen et al. 2008), and so far real earnings management is assumed to be correctly disclosed in financial statements so that it cannot affect auditor opinion .

In the agency theory perspective, auditor quality plays an important role in aligning the interests of shareholders and managers so as to reduce information asymmetry. Manipulation of income through normal business activities can only be detected if the auditor has specific knowledge and skills related to the client industry (Sun and Liu 2012), while many accounting scandals involve leading audit offices that have the skill and competent human resources. This phenomenon makes audit quality studies represented in the auditor industry specialization important. In addition not much research (Rusmin 2009; Chi et.al. 2011), the inconsistency of the results of previous studies in the relationship between earnings management and audit quality with auditors of industry specialization is inconsistent, for example, Chi et.al (2011) who found a positive relationship of industrial auditors in the real earnings management index. This result is supported by Havazi and Darabi (2016) who examine the quality of financial reporting. The opposite results were obtained by Rusmin (2010) who found a negative relationship. Zgarni et. Al. (2016) failed to prove the relationship of industry specialist auditors with earnings management

The objectivity and independence of auditors is a requirement for achieving a quality audit, especially independence in appearance, this reduced independence will reduce the quality of auditor work. When users of financial statements want an objective audit, the auditor must act so that the goal is achieved. (Brandon and Mueller 2006), objectivity is important because the level of auditor competence cannot always be done with a higher level of independence. One of the things that can reduce independence is economic dependence on clients because the clients' importance has an urge for auditors to

compromise with clients (DeAngelo 1981). Theoretically, the relationship of client importance with earnings management can be explained from two sides. Auditors whose business is highly dependent on one client (or very few clients) can be more tolerant of earnings management which means that client importance have a positive effect on earnings management. In addition, the importance of clients to auditors is a trigger for auditors to be more rigorous in monitoring to avoid loss of reputation or potential litigation. In other words, the greater the client's economic interests, the smaller earnings management due to close monitoring by the auditor. In addition to theoretical gaps, research on the importance of clients shows the results of inconsistencies. Sharma et.al. (2011) failed to prove the relationship between client importance and independence. Insignificant results were also obtained by Kwon et.al. (2004). While some studies can prove a negative relationship (Antle et al. 2006; Frankel et al. 2002; Larcker and Richardson 2004).

Literature review and hyphotesis

Real earnings management

In the perspective of agency theory, dividers between management and owners, opportunist management, and management flexibility as a result of asymmetric information can motivate management to make earnings management. Management intervenes by exploiting accounting policies or regulating operating business transactions intentionally to mislead users of financial statements about the company's business fundamentals or influence the outcome of contracts based on the number of accounting reported for the purpose of obtaining personal gain (Healy and Wahlen 1999). Accrual earnings management manipulates managerial income through estimates, accounting methods, and accounting estimates. Meanwhile, real earnings management is managerial intervention by manipulating earnings through actions that deviate from normal business practices (Sun, et. al. 2014; Khanh and Khuong, 2018; Roychowdhury, 2006). Managerial intervention on normal business activities is more difficult for auditors to detect than accrual earnings management, because real earnings manipulation does not refer to generally accepted accounting principles, and does not need to be disclosed in financial statements (Chou and Chan, 2018; Järvinen and Myllymäki, 2016). Managerial interventions to influence income through business activities are more difficult to find because of their hidden nature in normal business activities (Anagnostopoulou and Tsekrekos, 2016). For users of financial statements, real earnings management is very dangerous because of its hidden nature, affecting future cash flows that can endanger the company's value in the long run (Roychowdhury 2006; Cohen and Zarowin 2010, Gupta, et.al. 2010), and do not get auditor's attention because it is assumed to be correctly disclosed in financial statements so that it cannot affect the auditor's opinion (Cohen et al. 2008).

Auditor Industry Specialization and Real Earning Management

Auditors have a role to verify the reliability and fairness of financial statements, improve audit quality of financial information and reduce earnings management (Khanh and Khuong, 2018). In agency relationships, audit quality is recognized as the most important monitoring mechanism that can minimize agency costs and reduce conflict

management and owners (Yasser and Soliman, 2018). Quality audits describe the auditor's ability to detect and report material misstatements from financial statements (Gul et al., 2009). High audit quality produces high-quality financial reports and quality financial reports tend not to have material misstatement (Balsam et al., 2003), and consequently qualified auditors to tend to dislike earnings management. External auditor audit quality is a function of competence, objectivity, and independence which if not fulfilled will cause concerns about the loss of auditor confidence. Audits conducted by industry-specific audit firms tend to have higher quality because auditors or audit teams have industry-specific expertise (Carcello and Nagy, 2004).

The quality of monitoring depends on the auditor's ability to reduce the likelihood of abnormal business practices as an effort to make earnings management. Auditor specialists provide high-quality audit services that produce high-quality accounting information (Sun and Liu 2012). Audit quality arises because of the ability of specialists to detect manipulation. This ability arises auditors of industrial specialization gaining more industry-specific knowledge and having more industry expertise than non-specialized auditors (Dunn and Mayhew, 2004). Regarding external governance mechanisms, audit quality is considered an effective monitoring mechanism (Alzoubi, 2017). Audit quality in the context of monitoring is worrying and causes a decrease in trust due to threats to objectivity and independence. This concern arises because the quality of monitoring depends on the competence and independence of auditors (Zgarni, et. Al. 2016, and Jorjani and Gerayeli 2018). The audit quality of specialist auditors is higher than that of non-specialist auditors with the argument that specialists are expected to have deeper knowledge than non-specialists because of their expertise and experience in certain industries, client companies are willing to pay premiums for industry specialists that allow audit firms to make extra efforts to ensure higher audit quality, and auditor specialists will have strong incentives to provide a higher quality audit to protect themselves against litigation risk and consequently loss of reputation capital (Jaggi et.al. 2012). Furthermore, Rusmin (2010) states specialists that auditors tend to invest more in staff recruitment and training, information technology, and the latest audit technology from non-specialist auditors so that industry specialist auditors are expected to display superior performance.

Real earning management is directly related to a company's business transactions and company cash flow so that audits that apply can only be done by auditors who have special expertise in certain industries. Auditor industry specialization is more likely to verify the credibility of financial reporting (Krishnan 2003). Specialization industry auditors must recognize and understand certain issues from related industries, identify key organizations operating in the industry, and know how certain industry issues can affect various sectors throughout the industry (Kend, 2008), so that industry-specific auditors have performance which is superior to its peers (Solomon et al., 1999; Owhoso et al., 2002).

Previous research shows that industry specialist auditors have an important role in determining audit quality. Chi et.al. (2011) found that industry-level auditor industry expertise and audit costs are related to higher levels of earnings management. Rusmin (2010) whose research on discretionary earnings management shows that the amount of earnings management in companies that use audit services is significantly lower than

companies that use the services of non-specialist auditors. Research on fraudulent financial reports by Carcello and Nagy (2004) finds a significant negative relationship between industry auditor specialization and financial fraud if the auditor's market share is measured using audited client sales. In addition, there is usually a significant negative relationship between specialization and fraud if the auditor's market share is measured using the client's audited assets. Romanus et al. (2008) found the client industry expert auditor had a lower probability of restatement. Lim and Tan (2008) show that auditor specialists are more likely to worry about losing reputation and litigation exposure than non-specialists. Mayhew and Wilkins (2003) confirm that large market share companies are able to increase industry-specific knowledge and expertise leading to higher quality services than small market share companies. Audit firm are considered as specialists in the industry when they have the largest market share based on client sales or the number of clients audited by the company. Based on the theoretical exposure and previous research above, a hypothesis can be made as follows:

H_1: Auditor industry specialist have a negative effect on real earnings management

Client Importance and Real Earnings Management

Within the agency framework, the auditor acts as a third party that bridges the interests of management and company owners. The auditor is an independent party who is paid by the company, but the main user of the auditor's work is the owner of the company, in this condition auditor independence becomes a problem. Economically, this indicates that auditors will favor management rather than shareholders so that the auditor can lose its independence (Tepalagul and Lin, 2015). The auditor's incentive to compromise his independence to the client depends on how important the client is to the auditor (DeAngelo 1981). The auditor will retain the client if he has an important economic relationship (Francis and Yu 2009), and has a cost dependency, or economic dependence (Reynolds and Francis, 2000; Chen et al. 2010). It is possible that the greater the client size in the auditor's portfolio, the greater the incentive for the auditor to retain his client, where audit quality tends to be compromised (Chen et al. 2010).

The independence auditor can be seen from how far the auditor tolerates the earnings management by the client, the higher the quality of auditor independence, the lower earnings management. Park (2015) enlightens that the relationship between client importance and earnings management depends on the level of auditor independence which is reflected in the relative influence of managerial versus auditor incentives. Auditors will withstand client pressure on earnings management or other types of accounting when they are expected to relate to market-based institutional incentives from the benefits of retaining high-paid clients (De Fond, et al., 2002; Frankel et al., 2002; Park, 2015). This shows that the client's economic interests for the auditor can be a catalyst to strengthen auditor incentives to encourage auditor independence. Earnings management interventions in normal business activities usually lack the attention of auditors, even though these activities have an impact on the company's cash flow and corporate performance in the long run (Roychowdhury 2006; Cohen and Zarowin 2010, Gupta, et.al. 2010). In the ceteris paribus condition, if the auditor has a dependency on the client, then the auditor tends to ignore real earnings management activities. Under conditions of high client importance, auditors are less independent, so the possibility to

tolerate earnings manipulation is also high. Auditors assume that these earnings management activities need not be disclosed in financial statements (Järvinen and Myllymäki, 2016) and are not the responsibility of the auditor.

Client importance in previous research is largely related to accrual earnings management, for example, Park (2015), and Sharma et.al. (2011. Park (2015) proves that there is a positive relationship between clients and discretionary refusal for companies with high reputable auditors. Significant positive results are also documented by Sharma et al. (2011) which proves that clients whose income sources are significantly derived from non-audit costs affect earnings management for both long-term and short-term accruals. Based on the above explanation can be compiled the following hypothesis:

H_2: Client importance have a positive effect on real earnings management

Research Methodology

Sample and Data

This study examines manufacturing and trading companies from the 2012-2016 period. After being reduced by companies whose financial statements use foreign currency, incomplete financial statements and outlier data, the sample used in this study as many as 430 observation data for 118 companies. The sample in this study shows that the data in this study is pooling data. All data in this study were obtained from the Indonesia Stock Exchange (IDX) online site, www.idx.co.id.

Measurement

Real Earnings Management (REM)

The measurement of real earnings management in this study refers to the proxy used by Roychowdhury (2006) and Cohen et.al. (2008). Cohen et al. (2008) define a proxy for real earnings management based on low abnormal cash flow rates from operations and discretionary costs, and high abnormal production costs as an indicator of real activity manipulation. Abnormal cash flow (Abn_CFO), abnormal production costs (Abn_Prod), and abnormal discretionary expenditure (Abn_Discexp) are obtained from the residual value of equation (1), (2) and (3) Real Earning Management through Abnormal Production Costs (Abn_Prod) To calculate the normal level of production costs used regression models used in Roychowdhury's (2006)[0] research, according to the formula used

a. $\frac{Prod_{it}}{AssetsA_{it-1}} = \alpha_0 + \alpha_1 \left(\frac{1}{Assets_{it-1}}\right) + \alpha_2 \left(\frac{Sales_{it}}{Assets_{it-1}}\right) + \alpha_3 \left(\frac{\Delta Sales_{it}}{Assets_{it-1}}\right) + \alpha_4 \left(\frac{\Delta Sales_{it-1}}{Assets_{it-1}}\right) + \varepsilon_{it}$

(1)

b. Real Earning Management through Abnormal Cash Flow Operation (Abn_CFO)

$\frac{CFO_{it}}{Assets_{it-1}} = \alpha_0 + \alpha_1 \left(\frac{1}{Assets_{it-1}}\right) + \alpha_2 \left(\frac{Sales_{it}}{Assets_{it-1}}\right) + \alpha_3 \left(\frac{\Delta Sales_{it}}{Assets_{it-1}}\right) + \varepsilon_{it}$ (2)

c. Real Earning Management through Abnormal Discretionary Expense (Abn_Discexp)

$$\frac{\text{Discexp}_{it}}{\text{Assets}_{it-1}} = \alpha_0 + \alpha_1 \left(\frac{1}{\text{Assets}_{it-1}} \right) + \alpha_2 \left(\frac{\text{Sales}_{it}}{\text{Assets}_{it-1}} \right) + \varepsilon_{it} \tag{3}$$

d. Real Earnings Management

After obtaining the value of each proxy, then the flow of abnormal production costs, abnormal operating cash flows, and abnormal discretionary costs are summed to capture the overall effect of real earnings management.

$$REM = \text{Abn\_Prod} + \text{Abn\_CFO} + \text{Abn\_Discexp} \tag{4}$$

Client Importance

Client importance is defined as the relative financial importance of the company as a client for the Public Accounting Firm (KAP) (Kerler and Brandon, 2010). Client importance can be measured by the total assets of the audit firm client divided by the total amount of assets of all clients of manufacturing and trading companies listed on the Indonesian Stock Exchange.

Auditor Industry Specialization

Specialist industry auditors are measured by the amount of client assets in a particular industry divided by the total assets of all companies in a particular industry. This proxy is used with the assumption that the firm size reflects the amount of the auditor's efforts in allocating resources. The determination of specialists and non-specialists is carried out in three stages. In the first phase, identifying the number of companies in several types of industrial sub-sectors, there are at least 5 companies in the industrial sub-sector. The use of an audit company in determining this specialization with the consideration that audit partners can change, but usually the audit team stays the same. This sub-sector is used as a basis for determining industrial groups with the consideration that in industrial activities different sub-sectors of the company's activities and operations are also different, even though they are in the same industry. The second stage, calculating the auditor's portfolio in the industrial sub-sector by dividing the total assets of the client of a public accountant in a particular industrial sub-sector with the total assets of the company in a particular industrial sub-sector. The third stage, determines specialist industry auditors and non-specialists. If the portfolio results in stage 2 are greater than 30% then the auditor is classified as an auditor of industrial specialization and given a score of 1 and if it is smaller or equal to 30%, it is classified as a non-specialized industry auditor and given a score of 0.

Control Variable

The control variables in this study included total assets (TA), cash holding (CH), management ownership (MO), and audit committee competence (ACC). Company size reflects political costs, holding cash (Greiner (2017) reflects opportunistic management,

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leadership management, audit committee competence and effectiveness of board of directors (Xie et al. 2003) describes corporate governance All of these control variables reflect the internal conditions of the company. The company is derived from the natural log (ln) of assets. Cash holding are measured by the proportion of cash and cash equivalents divided by net assets Managerial ownership is measured by the shares held by the board of directors in the number of shares outstanding. and the board of directors: Committee audit competence is measured by the proportion of audit committee members with accounting or financial or economic education background with all members of the audit committee. The research use regression analysis to verify our hypothesis. The OLS regression model is as follows:

$$REM = \gamma 0 + \gamma 1CI + \gamma 2\ AIS + \gamma 3\ FS + \gamma 4CH + \gamma 5MO + \gamma 6ACC + \varepsilon$$

Results

Descriptive statistics in Table 1 show the maximum REM values of 1.86995, the minimum of 0.13059 and the REM mean of 1.04747. The mean value of REM in this study is higher than that of Park (2016) which has a mean of 0.003 with a minimum value of -1.998 and a maximum value of 1.046. CI has a minimum value of 0.00037 and a maximum value of 1.00 indicates that the distance between auditors who are economically dependent and auditors who are not economically dependent is very high. AIS shows the mode value for non-specialists from 303 or 70% observation data. This shows that companies prefer to choose a public accounting firm that is not a specialist.

Descriptive Statistic

Table1 Mean, Standard Deviation, Minimum and Maximum

	Mean	Std. Deviation	Minimum	Maximum
REM	1.04747	0.38567	0.13059	1.86995
CI	0.22694	0.28028	0.00037	1.00000
TA	9,067,734,851,235	27,325,330,924,919	6,816,874,399	261,855,000,000,000
MO	0.01586	0.06578	0.00000	0.49910
ACC	0.76101	0.26175	0.00000	1.00000
		Non AIS	AIS	
AIS	Mode	303	127	

The correlation in table 2 shows the minimum value of -0.017 and the maximum value of 0.499, this means that the relationship between the independent variables is not too strong and shows that there is no multicollinearity. The most interesting thing in table 2 is the correlation between AIS and CI of -0.113. No multicollinearity support by value of tolerance and variance inflation factor (see table 4). Negative signs on this correlation indicate that the two variables have opposite directions.

Table 2 Correlation between independent variable

	AIS	LnCI	LnTA	LnCH	MO	ACC
AIS	1	-0.137**	0.499**	-0.056	0.078	0.085
LnCI	-0.137**	1	0.210**	-0.017	0.091	-0.020
LnTA	0.499**	0.210**	1	0.212**	0.167**	0.081
LnCH	-0.056	-0.017	0.212**	1	0.152**	0.016
MO	0.078	0.091	0.167**	0.152**	1	0.059
ACC	0.085	-0.020	0.081	0.016	0.059	1

Normality test

Table 3 shows that the test statistics for unstandardized residues are 0.034 with asymp. Sig. (2-tailed) 0,200. These results prove that the testing of one sample kolmogorov smirnov for unstandardized residuals in this research model is normally distributed.

Table 3 One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
Normal Parameters[a,b]	Mean	0.0000000
	Std. Deviation	0.35288029
Most Extreme Differences	Absolute	0.034
	Positive	0.023
	Negative	-0.034
Test Statistic		0.034
Asymp. Sig. (2-tailed)		0.200[c,d]

Multicollinearity test

Table 4 Collinearity Statistics

	Tolerance	VIF
AIS	0.654	1.528
LnCI	0.858	1.165
LnTA	0.606	1.650
LnCH	0.890	1.124
MO	0.950	1.053
ACC	0.988	1.012

Heteroscedasticity test

Heteroskedasticity in this study was tested by using the Glejser test which regression residual absoilud (ABSRES) with all independent variables in accordance with the research model. The results of this test indicate that the significance (p value) for AIS is

0.838, LnCI is 0.641, LnTA is 0.713, LnCH is 0.164, MO is 0.782 and ACC is 0.206, this significance value is greater than 5% and can be stated that there is no problem heteroscedasticity.

Table 5 Glejser Test

	Unstandardized Coefficients		t	Sig.
	B	Std. Error		
(Constant)	0.426	0.228	1.869	0.062
AIS	0.005	0.026	0.205	0.838
LnCI	-0.003	0.007	-0.467	0.641
LnTA	-0.003	0.008	-0.368	0.713
LnCH	0.010	0.007	1.396	0.164
MO	-0.042	0.152	-0.277	0.782
ACC	-0.047	0.037	-1.267	0.206
a. Dependent Variable: ABSRES				

Durbin Watson value 1.979368 from table 6 was between du and 4-dl, which meant that there was no correlation between the data (no auto correlation) for the three research models. Anova test shows that F value 13.711316 significant at level 0,000. This shows that at least 1 variable in all three research models affects REM or it can be stated that this research model is in accordance with the data. Adjusted R square in this study is relatively low at 0.150945 (15,95%) this result is not much different from other studies using data integration or cross-sectional data.

Table 6 OLS Regression model for hypothesis test

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.619	0.402		-1.538	0.125
	AIS	-0.106	0.046	-0.126	-2.289	0.023
	LnCI	0.046	0.013	0.173	3.604	0.000
	LnTA	0.070	0.014	0.292	5.102	0.000
	LnCH	0.042	0.012	0.160	3.383	0.001
	MO	-0.354	0.268	-0.060	-1.325	0.186
	ACC	-0.058	0.066	-0.039	-0.872	0.383
Add. Information						
Durbin Watson		1.979368				
F value		13.711316				
P value (sig)		0.00000				
Adjusted R Square		0.150945				

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The variable of auditor of industry specialization in table 6 show t value -2.289 with coefficient regression (B) is -0.106. The t value of AIS is significant at 5% level and has a negative direction which means that AIS has a negative effect on REM. This shows that hypothesis 1 in this study was accepted. The LnCI in table 6 shows the t value of 3.604 and the regression coefficient of 0.046 provides evidence that CI significantly has a positive effect on REM at the level of 1% with a negative coefficient. This result provides evidence that hypothesis 2 is accepted and shows that LnCI has a positive effect on REM.

Discussion

In general, it can be stated that AIS has a negative effect on real earnings management which means specialist auditors can reduce the opportunistic attitude of management to intervene in real earnings management. Specialist auditor expertise has a competency that can detect real earnings management. Specialist auditors also lack tolerance for real earnings management actions undertaken by management. In the agency context, industry auditor specialists can act as independent external governance that can oversee management activities. In addition, AIS tend to reduce information asymmetry and decrease agency costs. The results of this study prove that auditors of industrial specialization have their role as competent parties in verifying the reliability and fairness of financial statements to reduce real earnings management. This result is in line with agency theory which places auditors as independent parties as external governance mechanisms to reduce information asymmetry and minimize agency costs (Yasser and Soliman 2018). Industrial auditors specialize in having the ability to reduce the possibility of abnormal business practices in an effort to make earnings management. The ability of auditors to detect real earnings management and misstatements in the audit process in line with quality audits. Audit quality is created because specialized industry auditors have industry-specific expertise (Carcello and Nagy, 2004), acquiring more industry-specific knowledge (Sun and Liu, 2012; Dunn and Mayhew, 2004), providing higher quality audits to protect themselves themselves against litigation risk and consequently loss of reputation capital (Jaggi et.al. 2012), and tend to invest more in staff recruitment and training, information on the latest audit technology and technology (Rusmin, 2010).

The result of this research support by some previous research. Chi et.al (2011) which found that audit quality with auditor industry expertise and the presence of a Big N audit firm as the proxy are associated with greater overall real earnings management at the city level. At the city level, the Individual component of real earning management associated with auditor industry expertise, i.e., lower abnormal cash flow and discretionary expenditures, and higher over-production. This result is also consistent with the findings of Rusmin (2010) which documented that the coefficients on specialists are negative and significant at p, 0.05. The negative and significant relationship between industry specialists and the value of absolute discretionary accruals as a proxy for earnings management is in line with the perception that the more specialist auditors, the more likely they will be able to limit the management intervention to accounting method and estimation. Balsam et.al. (2003) so documented that specialist industry auditors have earnings quality by discretionary accruals and earning response coefficients that are better than non-specialists. Havasi and Darabi (2016) examined companies listed on the Tehran Stock Exchange period 2008 to 2014 proving that auditor expertise in the industry measured by market share patterns based on income auditor's market share has a direct

impact on the quality financial reporting quality. Hegazy et.al. (2015) in the research failed to prove that industrial specialization can limit earnings management but succeeded in proving that auditors with industry specialization improved audit quality. Meanwhile, Zuo and Guan (2014) investigating the association industry specialization in earnings management in Chinese companies between 2008 and 2011 showed that there was no significant correlation between earnings management and auditor specialist industry, and a negative relationship only occurred with firms with earnings management reduced income. Zuo and Guan (2014) recommend that China should improve the improvement and maintenance of audit quality and continue to emphasize the implementation of policies to become a larger and stronger audit company. Furthermore, the cultivation of industry experts is also an important and urgent development strategy.

The positive impact of client importance on earnings manipulation in real business activities is supported by regulator and investor perceptions. Broader and stronger relations of auditors with clients will reduce auditor independence (DeAngelo, 1981), auditors should side with users. Park (2015) states that the relationship between auditor interests of clients and financial reporting quality depends on the relative impact of managerial versus auditor incentives. These results prove investors and regulators' doubts about auditor independence, despite market-based incentives and proactive precautions taken by audit firms. Sharma et al. (2011) have doubts about auditor independence, first, regulators believe when auditors depend financially on their clients, the auditor will take economic rent from non-audit services, and both the nature of non-audit service consulting can place auditors in managerial roles so that they are potentially threatening objectivity of the transaction being audited. Lack of auditor independence can increase the likelihood of being perceived as not objective, so that the auditor will not report any violations found (DeAngelo, 1981). The results of this study are in line with law enforcement in Indonesia that is still weak which relates to public accountants or public accounting firms. When law enforcement for the auditor profession is weak, auditors who have economic interests with clients tend to be less independent so they will tolerate real earnings management practices.

Previous research that related client importance with earnings management or audit quality is inconsistent. Many studies support the results of this study, Okolie (2014) examined the Nigerian Stock Exchange with 342 observation companies proving that auditor independence has a significant influence on the amount of discretionary accruals. Chen et.al. (2010) investigating in the Chinese context with a sample of 8,917 clients with observation periods 1995 to 2004 found that client importance measured at the level of individual auditors undermined audit quality, but not at the audit office level. This happened because of the possibility of issuing lower modified audit opinions (MAO) during the period 1995-2000 when the legal and regulatory institutions were weak. During the period of law and law enforcement improvement (2001-2004) there was also no evidence in the same period as a weak legal institution and law enforcement. Muzatko and Teclezion (2016) found facts with banking companies in the United States that prove that economic importance with clients proxied by higher audit costs tends to report higher discretionary accruals, both for the sample of all firms, negative discretionary accruals, and accruals positive discretionary. Lin et.al. (2017) with the Cubist Tree-Regression Model approach show that when clients have a net loss in the current year, the positive relationship between discretionary accruals and client importance is more important. This

means that when a client reports a net loss, the auditor can damage the independence of the client that presents a level acceptable audit risk. Park (2015) examines companies listed on the Korea Stock Exchange showing that, consistent with expectations, both the client's audit cost ratio to the audit company's total audit costs and the ratio of total client costs to total audit firm revenue are positive for all regression, but not significant, shows that there is no relationship between client importance and auditor tolerance for discretionary accruals that increase income used to achieve revenue targets.

Conclusion

Real earnings management activities have a direct impact on business decisions and cash flows (Barton and Simko, 2002) and are usually less attractive to auditors (Cohen et al. 2008), and are assumed to be properly disclosed so as not to affect auditor opinion. In the agency perspective, auditors have a role as an independent party that supervises as a form of external governance that can narrow the distance of information asymmetry between management and company owners which in turn minimizes the agency costs. Good monitoring by the auditor can only be done if the auditor is competent and objective in carrying out work. Real earnings management is a profit management activity that is directly in contact with the company's business so that it can only be detected by auditors who have specific competencies from the client industry. In addition, qualified auditors can only be done if the auditor is not economically dependent on the client so that it is not biased and intolerant to the practice of real earnings management.

This study examines manufacturing companies and trading companies registered in the Indonesian Securities Exchange in the period 2012 to 2016. The research sample was 430 observation data. The hypothesis was tested by multiple linear regression. The test results prove that the industry specialization auditor has a negative effect on real earning management and client importance has a positive effect on real earnings management. The results of this study redound to the auditor's profession that specialist expertise from an audit firm is very important because only an audit firm that has specialization is able to detect and reduce real earnings management. In addition, this study also proves that client importance will reduce the objectivity and independent attitudes of auditors which in turn will harm the auditor itself. Although all hypothesized variables are accepted, specialist auditor measurement variables and client importance need to be developed further. Specialization industry auditors can be measured specifically related to industrial competency certification for both audit firms and individual auditors. Importance clients can be measured by the audit fees obtained by the auditor.

This research contributes to investors that the use of industry specialization auditors can produce quality audits and that auditors who have client importance can result in non-independent auditors. Negative influences for industry specialization and positive auditors for the benefit of clients in this study prove that competence and independence attract in handling real earnings management practices in client companies. The government and regulators should make policies relating to industry specialization auditors and disclosure about client importance. The government or other regulators need to make policies regarding auditors that are allowed to audit certain industries. A good example in the Indonesian context is the regulation for auditors who are allowed to audit banks are auditors who already have financial and banking certificates as stipulated in

article 3 paragraph 3 of the Financial Services Authority Regulation Number 13/POJK.03/2017 concerning the Use of Public Accountant Services and Use of a Public Accounting Firm in Financial services. This research also contributes to the development of agency theory. Independent auditors can narrow information asymmetry and reduce agency costs if the auditor has a certain industry-specific expertise and does not have a large economic importance with the client. Regulations should also make policies regarding obligations for the benefit of economic clients, for example, the disclosure of non-audit services and audit fees. The results of this study have implications for investors that financial statements submitted by managers and management manipulating earnings through normal business activities can only be detected by auditors who have industry expertise. As such, investors must also be careful if the auditor or audit office that audits the company has economic importance with the client.

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