

## FINANCIAL DISTRESS AND MANAGERIAL ABILITY ON AUDIT FEE

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### ABSTRACT

**Research Purposes.** This paper examines the effect of managerial ability on audit fees, examines the effect of financial difficulties on the relationship between managerial ability and audit fees, and examines the effect of opportunistic reporting carried out by management in the form of earning management on audit fees.

**Research Method.** The studies that were carried out used secondary data from 139 non-financial companies listed on the Indonesia Stock Exchange from 2016 to 2020.

**Research Result and Findings.** Through a linear regression of panel data, the study found that higher amount of audit fees was positively influenced by the manager's ability to manage company resources and found that abnormal cash flow real earning management had a positive influence on audit fees. The study also found that financial difficulties did not moderate the relationship between a company's managerial ability and its audit fees, but found that companies with financial difficulties had higher audit fees.

### ABSTRAK

**Tujuan Penelitian.** Penelitian ini menguji pengaruh kemampuan manajerial terhadap biaya audit, pengaruh kesulitan keuangan terhadap hubungan antara kemampuan manajerial dan biaya audit, dan menguji pengaruh pelaporan oportunistik yang dilakukan manajemen dalam bentuk manajemen laba terhadap biaya audit.

**Metode Penelitian.** Penelitian ini menggunakan data sekunder dari 139 perusahaan non keuangan yang terdaftar dalam Bursa Efek Indonesia dari tahun 2016 hingga 2020.

**Hasil dan Temuan Penelitian.** Melalui regresi linear data panel, hasil penelitian menunjukkan bahwa kemampuan manajer dalam mengelola sumber daya perusahaan memberikan pengaruh secara positif pada biaya audit. Hasil penelitian juga menemukan manajemen laba riil metode arus kas abnormal memberikan pengaruh positif pada biaya audit. Selain itu, hasil penelitian juga menunjukkan bahwa kesulitan keuangan tidak memoderasi hubungan antara kemampuan manajerial suatu perusahaan dengan biaya auditnya, namun menemukan bahwa perusahaan dengan kesulitan keuangan memiliki biaya audit yang lebih tinggi.

### INTRODUCTION

Several decades ago, there were many accounting scandals experienced by well-known companies such as Enron, WorldCom, Tyco, and several other companies that had a major impact on the world economy and reduced investor confidence in published financial reports (Ebhodaghe & Omoregie, 2020). When viewed from

the perspective of the fraud diamond, one of the causes of this accounting scandal is the emergence of manipulation behavior by management with high capabilities in a company through the use of information asymmetry that exists between agents or management and principals or shareholders to manipulate financial statements due to incentive factors in the form of incentives financial difficulties

(Gul et al., 2018). This information asymmetry arises because there is no effective supervision carried out by shareholders or investors. One form of supervision that can be applied by shareholders to the company's management is through examination of the company's internal controls and financial report produced by trusted external parties such as external auditors. External auditors are independent parties outside the company that provide services to fulfill information needs for parties outside the company that are audited as a form of social control (Halim, 2015). In performing their services, the auditor will conduct negotiation discussions with the company to be audited regarding the amount of audit fees that must be paid by the company.

Krishnan & Wang (2015) conducted a study related to high managerial ability to reduce audit fees caused by decreased audit risk due to good earnings quality. Earnings quality in this study is a process of profit recognition within the company. High earnings quality indicates that the company uses conservative accounting standards and has a very influential cash flow, while low quality earnings indicate that the profits generated by the company come from earnings manipulation activities. But there are studies that find different results, such as research conducted by Lisic et al. (2016) which found that management with high capabilities has a low level of communication with the company's internal audit so that the quality of providing financial reports is of low quality. This makes auditors have a higher oversight risk which makes companies need to pay higher audit fees.

Based on the fraud diamond theory, fraudulent behavior such as opportunistic reporting can occur if there are incentives or pressure factors (Wolfe & Hermanson, 2004). In this case, the pressure experienced by management to carry out opportunistic reporting can come from the financial difficulties experienced by the company. Several previous studies have analyzed the relationship between financial difficulties and audits. Financial distress is a condition where the company experiences an inability to meet financial and other obligations when they fall due. Gul et al. (2018) found that financial difficulties can encourage opportunistic reporting behavior by managers with high capabilities as an action to meet

market expectations and encourage company performance to get more compensation. Maher et al. (1992) found that the economic crisis could also contribute to a reduction in audit fees due to effective bargaining between companies and auditors.

Gul et al. (2018) alludes to opportunistic reporting as an action that benefits management but harms shareholders. This form of opportunistic reporting can occur when earnings management can be interpreted as an intervention carried out in the process of reporting external financial statements by management to gain benefits for the manager (Schipper, 1989). Earnings management discussed in opportunistic reporting is an opportunistic type of earnings management which is defined as a management practice to maximize their own profits through the freedom of action they have in the company (Siregar & Utama, 2008). Azizah (2017) conducted research on opportunistic earnings management activities that are widely used by companies in Indonesia, this indicates that there is opportunistic reporting by management in Indonesian companies. Several previous studies have also found that earnings management can increase audit fees (Antle et al., 2006). According to Sulistiawan et al. (2011), earnings management can be done through matters related to accounting regulations or also known as accrual earnings management and through real activities or also known as real earnings management.

This study is an extension of the findings of Gul et al. (2018) related to the relationship between managerial ability, financial difficulties, and audit fees. The research that has been done by Gul et al. (2018) have concluded that the company's bankruptcy disaster encourages opportunistic reporting behavior by management but does not focus on the following opportunistic reporting. This study will not only prove that the findings of Gul et al. (2018) give the same results in Indonesia but also to see the effect of opportunistic reporting on audit fees as measured through earnings management.

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### Literature Review

#### *Agency Cost Theory*

The agency cost theory perspective is the

theoretical basis used to understand issues related to audit fees and managerial ability. Jensen & Meckling (1976) define agency relationship as a contractual relationship between agents or managers (management in a company) and principals or owners (shareholders). This relationship is owned by the principal employing agents to perform tasks in order to fulfill the interests of the principal.

#### *Bonding Cost Theory*

In understanding the issues related to the relationship between the auditor and his client, the theoretical basis used is the perspective of the bonding cost theory. Bonding costs are one of the three agency costs proposed by Jensen & Meckling (1976). Agency cost is a decrease in welfare experienced by the principal because of the difference between the principal and the agent. According to Jensen & Meckling (1976) in Scoot (2000) there are 3 (three) types of agency costs. First, monitoring costs are costs incurred to observe and restraint agent behavior. Examples of monitoring costs are audit fees, management compensation, budget restrictions, and operating rules. Second, bonding costs are costs incurred to ensure that the agent actions won't harm the principal interest. Third, residual loss is a decrease in the level of welfare of the principal and agent after the agency relationship. The bonding cost theory states that in order to reduce the conflict of interest between the principal and the agent, the principal will incur more costs to bond with the agent so they act in accordance with the interests of the principal.

#### *Fraud Diamond Theory*

In understanding management behavior in opportunistic reporting, the theoretical basis used is the perspective of the fraud diamond theory. Wolfe & Hermanson (2004) state that someone commits fraud or fraud is caused by three factors, namely opportunity, incentive, rationalization, and capability. Opportunity refers to the factors that make this fraud possible, such as the weakness of the company's internal controls. Incentives or pressures refer to the thoughts of the perpetrators that cause the perpetrators to commit fraud or as expected from above. Rationalization refers to the justification of the perpetrator to commit fraud such as when everyone commits fraud then the fraud is

justified. Capability is the ability of the perpetrator to commit the fraud.

#### *Friendly Board Theory*

The board has two roles, namely as an advisor and a monitor to management. In carrying out their role, the Board requires input in the form of information from management. Thus, management is faced with two choices, namely to provide information or retain information. If management chooses to provide information, the Board will provide better advice to management in managing its business. However, it will also increase the risk of the Board interfering in decision making as well as increased monitoring of management performance. This increased monitoring will discourage management from providing information to the Board and seek to maintain a passive relationship between management and the Board.

#### *Audit Fee*

According to Hanmei et al. (2021) audit fees are largely determined by audit risk and audit effort, which can be influenced by the characteristics of each client or also from the public accounting firm itself. In addition, DeAngelo (1981) and Whisenant et al. (2003) define audit fees as costs that vary in size due to several things such as the size of the client company, complexity, risk, and the name of the Public Accounting Firm that performs services.

#### *Audit Fee Model Framework*

The audit fee model framework developed by Houston et al. (2005) has included factors of auditor effort, audit-related litigation risk, residual litigation risk, and non-litigation risk. The framework made consists of three components as follows:

$$E(c) = cq + E(d) \times E(r) + E(g) \times E(l) + E(t) \times E(z) \dots (1)$$

Component 1 [ $cq + E(d) \times E(r)$ ] focuses on audit risk that can be reduced by audit procedures and audit effort. Component 2 [ $E(g) \times E(l)$ ] explains the auditor's price for litigation claims stemming from shareholder lawsuits due to excessive sales growth, share price volatility, and the possibility of clients experiencing financial failure which are generally not related to audit risk. Component 3 [ $E(t) \times E(z)$ ] relates non-litigation risk to losses the auditor may

incur for non-audit reasons and residual litigation risk, which may include future earnings loss due to the client's inability to pay current fees, reduced audit fees due to client poor financial condition, and negative reputation effects that affect fees received from clients in the future. For risks that cannot be reduced by components, the auditor responds by paying a premium or withdrawing from the engagement (Greiner et al., 2017).

#### *Managerial Ability*

Managers who have the ability to manage the company can be referred to as highly skilled managers. Puspita & Kusumaningtyas (2017) define managerial ability as personal characteristics or skills that encourage management to achieve good performance. Previous research stated that managerial ability can be defined as workers who provide superior company performance (Cheung et al., 2017), possess outstanding negotiation skills, and possess industry-related expertise (Demerjian et al., 2013). According to Baik et al., (2011), managerial ability is able to efficiently predict expected changes in the company's future performance and signal these skills by providing appropriate management earnings guidance.

#### *Financial Distress*

Financial distress signals one of the greatest environmental threats to business viability and profitability (Zhang & Huang, 2013). During this period, increased uncertainty and risk led to reduced demand from customers and an overreaction of investors to bad economic news. The client's financial distress will increase the auditor's litigation risk. Auditors will experience a higher difficulty in defending themselves from lawsuits by investors and creditors when the auditor fails to assess the client's ability to continue to operate or be a going concern (Raghunandan & Rama, 1995).

#### *Earning Management*

Earnings management is a practice of manipulating financial statements by managers with a specific purpose. According to Majid et al., (2020) earnings management is defined as the practice of managers who can flatten, increase, or decrease profits. Siregar & Utama (2008) say that earnings management has 2 types, namely

opportunistic earnings management and efficient earnings management. Efficient earnings management which aims to increase earnings information in communicating personal information while opportunistic earnings management, namely, management reporting earnings opportunistically to aim to maximize its utility. In addition, earnings management is also categorized as according to Sulistiawan et al. (2011) which defines earnings management into two, namely earnings management through accounting policies or accruals and earnings management through real activities. Sulistyanto (2008) defines accrual earnings management practice as an activity to play with accrual accounting components in the company's financial statements. This is because the accrual component is relatively easy to modify according to the wishes of those who do things related to the recording of financial statements.

#### *Hypotesis Development*

##### *Managerial Ability Affects Audit Fees*

Scott (1976) found that high managerial ability contributes to audit risk. Demerjian et al. (2013) found that high managerial ability has a positive effect on better financial reporting quality. Krishnan & Wang (2015) also prove that high managerial ability reduces audit fees due to good earnings quality, thereby reducing existing audit risk.

Previous results show that high managerial ability negatively impact audit fees. Krishnan & Wang (2015) have researched the relation between managerial ability (the ability to convert company resources into revenue), audit fees, and auditor's opinion of company activities during 2000-2011. In their, Demerjian et al. (2012) model is used for the purpose of finding the level of managerial ability. They found that managerial ability can reduce audit fees. This is in accordance with the agency cost theory defined by Jansen & Meckling (1976) as the amount of costs incurred by the principal to supervise the agent. Agency cost and bonding costs are used as the theoretical basis for this hypothesis. Bonding cost states that the amount of fees that must be charged to the agent in order to always act in accordance with the wishes of the principal. In this hypothesis, management acts as an agent employed by shareholders and will try to minimize audit costs through improving earnings quality.



Management with high capability has the ability to improve earnings quality and reduce audit risk so that audit costs incurred by the company are low.

Several studies found different results. Hendry (2002), Tian (2014), and Cheung et al. (2017) find that highly skilled managers can be better able to engage in enriching their wealth and harming shareholders. Lisic et al. (2016) found the quality of providing low financial reports in companies with high managerial abilities. Both of these things cause the auditor to increase audit risk within the company which leads to an increase in audit fees. Through the previous literature and using the perspective of the bonding cost theory, this study develops the following hypotheses:

H<sub>1</sub>: Managerial ability has a negative effect on audit fees

#### *Financial Difficulties Affect the Relationship between Managerial Ability and Audit Fee*

Gul et al. (2018) proves that financial difficulties encourage managers to make opportunistic reporting due to declining company performance. Opportunistic reporting by management due to pressure from the company's financial difficulties will cause information held by a company to be wrong and harm shareholders. As a responsibility to shareholders, companies must increase the audit fees incurred so that external auditors can carry out a more in-depth audit process so that the information contained in the report can be traced more thoroughly.

Several other studies found that there were cases of significantly decreased audit fees due to increased competition during the world economic crisis of 1970-1980 (Maher et al., 1992). Intense competition has led to aggressive audit fee negotiations and aggressive tendering of audit services (Beattie & Fearnley, 1994).

The fraud diamond theory is used as the theoretical basis for this hypothesis. The diamond fraud theory states that management will behave more opportunistically if there are incentives or pressures such as investor expectations. In this case, investors will expect management to improve the company's performance when the company is experiencing financial difficulties. High-capability management also has the capability to commit fraud because they know the internal controls of a company. These two factors encourage management with high capabilities to conduct

opportunistic reporting. This will have an impact on increasing audit fees because the auditor as a delegated party will be more vigilant in auditing the financial statements prepared by management. Through the previous literature and using the perspective of the fraud diamond theory, the author This study develops the following hypotheses:

H<sub>2</sub>: Financial difficulties have a negative effect on the relationship between managerial ability and audit fees

#### *Earnings Management Affects Audit Costs*

Siregar & Utama (2008) conducted a study related to earnings management used by Indonesian public companies, they found that public companies in Indonesia adhered to the efficient type of earnings management. Azizah (2017) conducted a similar study to see the types of earnings management commonly used by Indonesian companies. The study was conducted using samples from 1991 to 2015. In her research, Azizah found that companies in Indonesia are more likely to carry out opportunistic earnings management.

Accrual earnings management is one of the important instruments used by companies in manipulating earnings, especially in financial statements. The level of accrual earnings management is a factor that increases audit risk. The more risks the auditor finds, the more effort and time it takes to conduct an audit of the company's financial statements. So it is almost certain that the cost of audit services will increase. This is in accordance with research conducted by Schelleman & Knechel (2010) which shows that auditors will increase their efforts in conducting audits with higher-than-expected short-term accruals as an indication of earnings management. In addition, Alali (2011) found that the relationship between discretionary accruals and audit service fees increased significantly when the CFO bonus increased.

Hackenbrack et al. (2014) conducted interviews with five part-time audits from three Big 4 KAPs in the United States. The results show that most of the audit fees are contracts with a fixed fee value with audit service fees for additional services that must be approved by the client's audit committee. This shows that audit service fees or contracts with fixed audit fees are negotiated by the auditor based on the auditor's expectations of the

amount of earnings management. Through the framework of the audit fee model developed by Houston et al. (2005) which divides audit fees into three components, namely into components of direct costs related to audit procedures and risks that are directly related to it along with additional audit procedures, components of litigation costs, and components of non-litigation costs. In the first cost component, accrual earnings management will increase audit risk which causes this component to be high because the auditor must use more resources to audit the report in accordance with the findings of Schelleman & Knechel (2010). In the second component, Zhu (2016) found that high accrual earnings management has a positive relationship with the possibility of falling company stock prices. This is one of the litigation risks that can be borne by the auditor causing an increase in the second component.

H<sub>3</sub>: Accrual earnings management has a positive effect on audit fees

#### *Real Earnings Management Affects Audit Costs*

Choi et al. (2021) and also Greiner et al. (2017) find that real earnings management can increase audit fees. This is because real earnings management will increase the audit risk determined by the auditor (Greiner et al., 2017).

The audit fee framework developed by Houston et al. (2015) which divides things into three components of the effect of audit fees. Namely being a component of direct costs related to audit procedures as well as risks that are directly related to these matters along with additional audit procedures, components of litigation costs, and components of non-litigation costs. The first cost component is carried out during the preliminary procedure stage. The auditor will carry out an inherent risk assessment that is likely to occur, such as detecting the risk of material misstatement of analytical procedures, testing transactions, and comparing unaudited account balances. This stage will determine whether the company has earnings management risk or not. If it is indicated to carry out earnings management, the auditor needs to conduct more risk-related examinations which will increase audit fees, this is in accordance with research conducted by (Greiner et al., 2017). The second component of Francis et al. (2016) finds that

companies involved in real earnings management increase the risk of falling share prices in the following year. Earnings manipulation that occurs certainly affects financial information, it will affect when there is a possibility that the company is in trouble, this becomes the risk of auditor litigation because the company can make claims if the auditor fails to detect it.

Choi et al. (2021) found that real earnings management has a positive effect on audit fees. It suggested that increase in earnings manipulation in real activities will increase the fees paid to the auditor. Real management can increase overall audit risk through increasing audit complexity as well as litigation and reputational risk to the auditor. This causes the auditor to charge a higher audit fee to the company because the auditor requires more effort and resources in conducting the audit process. Greiner et al. (2017) find that real earnings management can increase audit fees. The study states that real earnings management activities will increase the audit risk determined by the auditor in determining the amount of audit fees. Through the previous literature and the audit fee framework developed by Houston et al. (2005), the hypotheses developed are as follows:

H<sub>4</sub>: Real earnings management has a positive effect on audit fees

## **RESEARCH METHODS**

### Research Data and Sample Selection

The data used in this study is secondary data, namely financial data used for research will be obtained through the Capital IQ website as well as company financial reports that have been published and are open to the public from 2016 to 2020. The data taken is panel data from companies listed on the Indonesia Stock Exchange in the period 2016 to 2020. Out of the total population of 448 companies, the sample that successfully met the selection criteria was only 139 companies. The list of sample selection according to the criteria is presented in the following table:

**Table 2. Descriptive Statistics**

Criteria	Observation Data
Non-financial companies listed on the IDX and operating in 2016-2020	448 Companies
Companies that do not publish annual reports and/or have incomplete data	76 Companies
Companies that don't disclose audit fees	233 Companies
Total samples	139 Companies

Research Variables

Dependent Variable

In the research conducted, the dependent variable used is audit fees. In accordance with research conducted by Gul et al. (2018), audit fees are measured using the natural log of audit fees. Audit fees are obtained through the financial statements of each company. The audit fee variable can be calculated using the following formula:

$$\text{Ln(AF)} = \ln(\text{Biaya Audit}) \dots\dots\dots(2)$$

Independent Variable

In the research conducted, the main independent variables used include: managerial ability, accrual earnings management, and real earnings management.

Managerial ability is measured through the model of managerial ability made by Demerjian et al. (2012), that used Data Envelopment Analysis (DEA). DEA is a statistical procedure used to measure the efficiency of a decision making unit (DMU) that converts certain inputs into outputs (Demerjian et al., 2012). In measuring managerial ability, the DMU used in the DEA calculation is a company with a consideration of one output, namely the company's sales revenue and seven specific inputs: inventory costs; selling, general and administrative expenses; housing, plants and equipment; operating lease; research and development spending; goodwill; and other intangible assets. All of these inputs contribute to the creation of sales revenue and are influenced by managerial ability because each input is influenced by the discretion of management (Demerjian et al., 2012). Managerial ability can be calculated through the formula:

$$\text{Max} \delta \theta = \text{Sales} / (\theta_1 \text{COGS} + \theta_2 \text{SG\&A} + \theta_3 \text{NPPE} + \theta_4 \text{R\&D} + \theta_5 \text{Goodwill} + \theta_6 \text{OtherIntan}) \dots\dots\dots (3)$$

The existence of accrual earnings management in a company can be seen using the discretionary accrual variable. This study uses discretionary accrual calculations through the Adjusted Jones Model. Discretionary accruals are the difference between the company's actual accruals and the normal level of accruals. Discretionary accruals are calculated from earnings before extraordinary items and discontinued operations minus operating cash flows. The discretionary accrual variable can be calculated using the formula:

$$\frac{TA_{it}}{A_{it-1}} = [\beta_{1it} \left(\frac{1}{A_{it-1}}\right) + \beta_{2it} \left(\frac{\Delta REV_{it}}{A_{it-1}} - \frac{\Delta REC_{it}}{A_{it-1}}\right) + \beta_{3it} \left(\frac{PPE_{it}}{A_{it-1}}\right) + e_{it}] \dots\dots\dots (4)$$

The existence of real earnings management can be measured through three variables, among others: abnormal operational cash flow, abnormal production costs, and abnormal operational costs. Formula for abnormal operational cash flow:

$$\frac{CFO_{it}}{AT_{it-1}} = \alpha + \beta_1 \left(\frac{1}{AT_{it-1}}\right) + \beta_2 \left(\frac{Sit}{AT_{it-1}}\right) + \beta_3 \left(\frac{\Delta Sit}{AT_{it-1}}\right) + e_{it} \dots\dots\dots(5)$$

AT is total assets and CFO is operational cash flow. Formula for abnormal production costs:

$$\frac{PROD_{it}}{AT_{it-1}} = \alpha + \beta_1 \left(\frac{1}{AT_{it-1}}\right) + \beta_2 \left(\frac{Sit}{AT_{it-1}}\right) + \beta_3 \left(\frac{\Delta Sit}{AT_{it-1}}\right) + \beta_4 \left(\frac{\Delta S_{it-1}}{AT_{it-1}}\right) e_{it} \dots\dots\dots(6)$$

PROD is the production cost obtained through the final price of sales plus changes in inventory.

Formula for abnormal operational costs:

$$\frac{DISEXP_{it}}{AT_{it-1}} = \alpha + \beta_1 \left(\frac{1}{AT_{it-1}}\right) + \beta_2 \left(\frac{Sit}{AT_{it-1}}\right) + e_{it} \dots\dots\dots (7)$$

DISEXP represents selling and general and administrative expenses.

Control Variable

The control variables in this study include company size as measured by company size (TA), company complexity as measured by the number of business segments within the company (SEG),

company financial performance as measured using return on assets (ROA), receivables inventory ratio measured by measured using the company's inventory and accounts receivable (INVREC), and the public accounting firm used by the company (BIG\_N).

Moderating Variables

The moderating variable used in this study is financial difficulties. Ohlson (1980) formulated the o-score to calculate the financial distress of a public company as follows:

$$T = -1.32 - 0.407 \log \left( \frac{TA_t}{GNP} \right) + 6.03 \frac{TL_t}{TA_t} - 1.43 \frac{WC_t}{TA_t} + 0.0757 \frac{CL_t}{CA_t} - 1.72X - 2.37 \frac{NI_t}{TA_t} - 1.83 \frac{FFO_t}{TL_t} + 0.285Y - 0.521 \frac{(NI_t - NI_{t-1})}{|NI_t| + |NI_{t-1}|} \dots\dots\dots(8)$$

**Description:** T is O-score, TA is total assets, GNP is gross national product index level, TL is total liabilities, WC is working capital, CL is short-term liabilities, CA is current assets, X is worth 1 if total liabilities are greater than total assets, NI is net income, FFO is funds from operations, and Y is 1 if the company has recorded profit and loss for the last 2 years. Companies that have an o-score above 0.5 are predicted to be unable to pay their bonds in the next 2 years.

Research Model

The regression analysis model used follows the model used by Gul et al. (2018) by adding the independent variables of earnings management.

$$\begin{aligned} \ln(AF)_{it} = & \beta_0 + \beta_1 MGR\_ABILITY_{it} + \beta_2 DISTR_{it} + \beta_3 MGR\_ABILITY * DISTR_{it} \\ & + \beta_4 PROD_{it} + \beta_5 CFO_{it} + \beta_6 DISEXP_{it} + \beta_7 DA_{it} \\ & + \beta_8 ROA_{it} + \beta_9 INVREC_{it} + \beta_{10} SIZE_{it} + \beta_{11} BIG\_N_{it} \\ & + \beta_{12} SEG_{it} + e_{it} \dots\dots\dots(9) \end{aligned}$$

**Description:** Ln(AF): Natural logarithm of audit fees, MGR\_ABILITY: Managerial ability, DISTR: Financial difficulty, MGR\_ABILITY\*DISTR: Moderation of managerial ability and financial difficulty, PROD: Absolute value of real earnings management production costs, CFO: Absolute value of earnings management real cost of cash flow, DISEXP: Absolute value of real earnings management discretionary expense, DA: Absolute value of discretionary accruals, ROA: Return on assets ratio, INVREC: Receivable inventory ratio SIZE: Firm size, BIGN: Public Accounting Firm, 1: Big Four ; 0: Non-Big Four, SEG: Segmentation of the company's business.

**RESULTS AND DISCUSSION**

Result

Descriptive Statistics

Table 3 is the result of descriptive statistics of the research sample. It can be seen that the average audit fee (Ln(AF)) of the companies included in the research sample each year is 6.7061. The data used for the audit fee variable (Ln(AF)) has been adjusted using the natural logarithm, this is due to the amount of audit fees from each company which has a fairly large range of values. So that the value adjustment is made. The standard deviation for the independent variable audit fee (Ln(AF)) is 1.1697. Then the minimum and maximum values are considered to have quite a large difference, namely at 3.8448 and 11.0883. In the study, the companies that held the highest audit fees were TLKM companies in 2016, 2017, 2019, and 2020.

The managerial ability (MGR\_ABILITY) has The average score of 0.5310 was obtained by calculating the average managerial ability (MGR\_ABILITY) of each company using the Data Envelopment Analysis (DEA) calculation method each year, which was 180 data in a score range of 0.400 - 0.499. The standard deviation of the earnings management variable (MGR\_ABILITY) is 0.2169. The maximum result is at number 1, which is as many as 26 data, with number 1 indicating the most efficient company management. Companies that often get a score of 1 are Faudit moMII and TLKM companies. For 4 years FMII and TLKM got an efficient score of 1. So it can be concluded that in this study only 3.74% of company data got the most efficient managerial ability assessment score. While the minimum result of the managerial ability variable (MGR\_ABILITY) is at 0.02, namely the BIPI company. About 26% of the company's data still get an efficiency score below the average. This means that there are still 26% of company data that have low managerial efficiency.



**Table 3. Descriptive Statistics**

	Variable	Obs	Mean	Std. Dev.	Min	Max
Dependent Variable	Ln(AF)	695	6.71	1.17	3.84	11.08
	MGR_ABILITY	695	0.53	0.22	0.02	1.00
Independent Variable	DISTR	695	2.61	2.46	-4.93	27.33
	PROD	695	0.14	1.26	0.00	16.50
	CFO	695	0.17	0.19	0.00	1.42
	DISEXP	695	0.00	0.01	0.00	0.22
	DA	695	0.06	0.13	0.00	2.97
	ROA	695	0.03	0.15	-2.88	1.29
	INVREC	695	0.30	0.19	0.00	0.92
Control Variable	SIZE	695	15.32	1.51	10.79	19.32
	BIG_N	695	0.41	0.49	0.00	1.00
	SEG	695	2.72	1.55	1.00	8.00

Source: Processed data, 2022

**Description:** Ln(AF): Natural logarithm of audit fees, MGR\_ABILITY: Managerial ability, DISTR: Financial difficulty, MGR\_ABILITY\*DISTR: Moderation of managerial ability and financial difficulty, PROD: Absolute value of earnings management real production costs, CFO: Absolute value of earnings management real cost of cash flow, DISEXP: Absolute value of real earnings management discretionary expense, DA: Absolute value of discretionary accruals, ROA: Return on assets ratio, INVREC: Receivable inventory ratio SIZE: Firm size, BIGN: Public Accounting Firm, 1: Big Four ; 0: Non-Big Four, SEG: Segmentation of the company's business.

Financial Distress (DISTR) has an average of 2.6198. This shows that many companies included in the research sample are experiencing financial difficulties. In this study, the calculation of the financial distress variable (DISTR) was measured using the O-score with each company showing results above 0.5 indicating high financial difficulties and tending to not be able to pay bonds for two years. The standard deviation of the financial distress variable (DISTR) is 2.4579 with a minimum value of -4.9312 and a maximum value of 27.3291. The company with the highest level of financial difficulty in the study is the AISA

company. Gul et al. (2018) who conducted a research on managerial ability on audit fees with financial difficulties using the Demerjian et al. (2012) research sample resulted in an average financial difficulty which also used the O-score calculation model of 0.1199, which was different from the results of this study which resulted in the number 2.6196. Companies in the research sample indicate much higher financial difficulties than research conducted by Gul et al. (2018).

#### Hypothesis Testing

Hypothesis testing was carried out using panel data regression test with Moderated Regression Analysis to test interactions and Random Effect Model as the best panel data regression model to use (Ghozali, (2018). Based on the results of hypothesis testing, the hypothesis tested in this study is estimated through the regression model equation in the form of panel data as follows:

$$\text{Ln(AF)}_{it} = 0.7889 + 0.5967\text{MGR\_ABILITY}_{it} + 0.0739\text{DISTR}_{it} - 0.0343\text{MGR\_ABILITY} * \text{DISTR}_{it} - 0.0244\text{PROD}_{it} - 0.4435\text{CFO}_{it} + 11.5973\text{DISEXP}_{it} - 0.1232\text{DA}_{it} + 0.6187\text{ROA}_{it} - 0.9043\text{INVREC}_{it} + 0.3394\text{SIZE}_{it} + 0.4574\text{BIG\_N}_{it} + 0.0799\text{SEG}_{it} + e_{it} \dots(9)$$

**Table 4. Hypothesis Test Results**

Variable	Coef.	Robust Std. Err.	z	P>z
MGR_ABILITY	0.6495	0.2603	2.5000	0.0130**
DISTR	0.0764	0.0425	1.8000	0.0720*
MGR_ABILITY*DISTR	-0.0386	0.0670	-0.5800	0.5640
PROD	-15.3425100	61366.6600	-0.2500	0.8030
DA	-0.1471	0.3480	-0.4200	0.6730
OCF	-0.4349	0.2117	-2.0500	0.0400**
DISEXP	10.7441	11.9344	0.9000	0.3680
ROA	0.6586	0.3015	2.1800	0.0290**
BIG_N	0.4605	0.0936	4.9200	0.0000***
SEG	0.0778	0.0297	2.6200	0.0090***
INVREC	-0.8471	0.1993	-4.2500	0.0000***
SIZE	0.3427	0.0365	9.3800	0.0000***
cons	0.8674	0.5149	1.6800	0.0920
Adjusted R-sq	0.6090			
Prob > chi2	0.0000			

Source: Processed data, 2022

**Description:** Ln(AF): Natural logarithm of audit fees, MGR\_ABILITY: Managerial ability, DISTR: Financial difficulty, MGR\_ABILITY\*DISTR: Moderation of managerial ability and financial difficulty, PROD: Absolute value of earnings management real production costs, CFO: Absolute value of earnings management real cost of cash flow, DISEXP: Absolute value of real earnings management discretionary expense, DA: Absolute value of discretionary accruals, ROA: Return on assets ratio, INVREC: Receivable inventory ratio SIZE: Firm size, BIGN: Public Accounting Firm, 1: Big Four ; 0: Non-Big Four, SEG: Company business segmentation, \*\*\* p<0.01, \*\*p<0.05, \* p<0.1

#### Discussion

##### *Effect of Managerial Ability on Audit Cost*

The first hypothesis states that managerial ability has a significant negative effect on audit fees. Based on the results of the statistical hypothesis test the probability value of the managerial ability variable (MGR\_ABILITY) is 0.013 (<0.05) with a coefficient value of 0.5967 (positive), it can be interpreted that managerial ability (MGR\_ABILITY) has a significant positive effect on

audit fees (Ln(AF)) . Thus the first hypothesis (H1) is rejected.

This study contradicts the results of research obtained by Demerjian, et al., (2013) and Krishnan & Wang (2015) who found high managerial ability to have a significant negative effect on audit fees. The higher the management's ability, the risk obtained by the auditor will be smaller. High managerial ability will contribute more to the collection of financial information and prevent the occurrence of risks. Scott (1976) found that highly skilled managers are willing to redouble their efforts to mitigate agency risks and problems. So the company pays a smaller audit fee to the Public Accounting Firm. Krishnan & Wang (2015) who studied the relationship between managerial ability and audit fees and found that the level of managerial ability affects the opinion given by the auditor, so that increasing managerial ability can reduce audit fees and the possibility of termination of company activities by the auditor. This study is not in line with part of the agency cost theory, namely the bonding cost theory by Jansen & Meckling (1976) as the amount of costs incurred by the principal to supervise agents. Bonding costs are used as the theoretical basis for this hypothesis.

Bonding cost states that the amount of fees that must be charged to the agent in order to always act in accordance with the wishes of the principal. When management has good results in carrying out company operations, the risks that should be found by the auditors do not occur because management with high capabilities has the ability to mitigate these risks so that there is a possibility of termination of company activities by the auditors. This makes the audit fees paid will be lower.

This study is in line with the research found by Lisic et al. (2016), Hendry (2002), Tian (2014) and Cheung et al. (2017), who found management to be self-interested and found that management with high capabilities had low communication with the company's internal audit so that the quality of the provision of financial reports provided has a low quality. This makes auditors have a higher oversight risk which makes companies need to pay higher audit fees. The findings of Lisic et al. (2016) is based on the friendly boards theory developed by Adams & Ferreira (2007) which states that directors will be reluctant to provide information to the board because information will encourage a stronger monitoring role even though the board of directors will receive better advice. Lisic et al. (2016) mention that management can take advantage of the company's control weaknesses to improve their own welfare and management with higher capabilities will be better at retaining information from internal audit and the board causing the company's internal controls to become more ineffective. This ineffective internal control of the company causes the auditor to increase audit risk and the auditor's effort in the audit process and causes higher audit fees.

Lisic et al. (2016) explained that the performance of the audit committee in the company is very dependent on the information provided by the management and the management of the company with higher capabilities will be able to store more information on the audit committee. The amount of information retained by the management will affect and can reduce the effectiveness of the monitoring of the audit committee within the company, thereby increasing the audit risk perceived by the external auditor. Skaife et al. (2013) show that the weakness of the company's internal control has a relationship with the high level of information trading within the company. Thus, the existing internal weaknesses of the company and

the incentives received from trading this information are factors that encourage management to maintain information so that the company's internal controls remain weak.

#### *The Effect of Financial Distress on the Relationship between Managerial Ability and Audit Costs*

The second hypothesis states that financial difficulties have a significant negative effect on the relationship between managerial ability and audit fees. Based on the t-test the probability value of the moderating variable of managerial ability and financial difficulties (MGR\_ABILITY\*DISTR) on audit fees is 0.564 with a coefficient value of -0.0386. The study did not find strong evidence that financial difficulties had an effect on the relationship between managerial ability and audit fees because the probability value of the test results showed an insignificant value. However, the study found that the financial distress variable had a significant positive effect on audit fees with a probability value of 0.072 (>0.05) and a coefficient value of 0.0764 (positive). When compared to the results of hypothesis testing conducted by each variable of managerial ability and financial difficulty, the results were 0.013 (<0.05) for managerial ability and 0.072 (>0.05) for financial difficulties.

Thus, the second hypothesis (H2) has not been accepted and this study does not support the findings of Gul et al. (2018) and the theoretical basis for the fraud diamond which is the basis for the hypothesis. The study found that the incentive factor in the form of financial difficulties did not cause management with high capabilities to be more opportunistic and the relationship between managerial ability and audit fees in companies experiencing financial difficulties was not the same.

#### *Effect of Accrued Earnings Management on Audit Costs*

The third hypothesis states that accrual earnings management has a significant positive effect on audit fees. Based on the t-test of the probability value of accrual earnings management (DA) variable of 0.673 (>0.5) with a coefficient value of -0.1471 (negative), it can be interpreted that accrual earnings management (DA) has no significant effect on audit fees.

Thus, the third hypothesis (H3) is rejected and this finding is not in line with the findings which show that accrual earnings management has a

significant positive effect on audit fees. What can explain the cause of this finding is that significant effect of discretionary accruals on audit fees due to the incentives received by auditors in companies that have positive discretionary accruals are different from companies that have negative discretionary accruals (Choi et al., 2006).

This study is not in line with the findings of Schelleman & Knechel (2010), Alali (2011), Hackenbrack et al. (2014) which show that auditors will increase their efforts in auditing in the presence of higher-than-expected short-term accruals as an indication of earnings management.

#### *Effect of Real Earnings Management on Audit Costs*

The fourth hypothesis which states that real earnings management has a significant positive effect on audit fees. In this study, real earnings management variables were measured by three approaches, namely real earnings management abnormal production costs (PROD), real earnings management abnormal operating cash flows (CFO), and real earnings management abnormal discretionary expenses (DISEXP).

Based on the results of the t test, the probability value of the variable real earnings management abnormal production costs (PROD) is 0.803 ( $> 0.05$ ) with a coefficient value of -0.0177 (negative), it can be interpreted that the real earnings management abnormal production costs (PROD) does not have a significant effect. negative on audit fees (Ln(AF)).

The results of the t-test probability value of the variable real earnings management abnormal operating cash flow (CFO) of 0.04 ( $< 0.05$ ) with a coefficient value of -0.4349 (negative), it can be interpreted that real earnings management operating cash flow abnormal (CFO) has a significant negative effect on audit fees (Ln(AF)).

The results of the t-test probability value of the variable real earnings management abnormal discretionary expense (DISEXP) of 0.368 ( $> 0.05$ ) with a coefficient value of 10.7441 (positive) then it can be interpreted that real earnings management abnormal discretionary expense (DISEXP) does not have a significant effect positive on audit fees (Ln(AF)).

Thus, the results of the fourth hypothesis test (H4) can be partially accepted, namely real earnings management which has a significant influence on

audit fees (Ln(AF) is real earnings management through operating cash flow. The results of the study are not in line with the findings of Choi et al (2021) and Greiner et al. (2017) which found that real earnings management has a significant positive effect on audit fees. On the other hand, the results of the study are in line with the findings of Ratmono (2010) real earnings management is still difficult to detect by analysts. This is because the auditor's manipulation of real activities comes from decisions on operational activities carried out by the company such as prices, expenses, and production.

#### CONCLUSIONS

The study was conducted to see the effect of managerial ability on audit fees and to see the effect of a company's financial difficulties on the relationship between managerial ability and audit fees in Indonesia. Research was also conducted to see the effect of earnings management on audit fees because previous research found that managers with high capabilities tend to make opportunistic reporting which can be done in the form of earnings management. Through a sample of 139 companies in Indonesia with a period of 5 years from 2016 to 2020, the study found that managers with high capabilities increased the audit fees received by auditors. However, the study did not find a significant relationship between some types of earnings management and audit fees. The findings only found that abnormal cash flows have a negative effect on audit fees, indicating that real earnings management has a positive effect on audit fees. Thus, managerial ability has a positive influence on audit fees due to the risk of earnings manipulation perceived by the auditors encouraging the auditor to re-examine earnings. However, of the four earnings management measurements, only one earnings management can be detected by the auditor and causes an increase in audit fees, namely real earnings management through operating cash flows.

There are several research limitations in research related to measuring managerial ability with data envelopment analysis or DEA. The measurement of managerial ability with DEA only measures the ability of all managers in the company to manage resources and does not look at the managerial ability of each individual in the



company. DEA only measures the managerial ability of operations management in managing the company's resources but does not measure the managerial ability of the management responsible for monitoring or controlling operations management activities. Through this study, the next researchers can determine the effect of the existence of individuals with certain managerial abilities (industrial knowledge or financial management) on audit fees. Second, research related to managerial ability on audit fees uses measurements of the number of the Board of Commissioners, members of the internal audit committee, the number of meetings held between the board of directors and commissioners, as well as the expertise of members of the Board of Commissioners and the internal audit committee.

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