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Opportunistic Perspective off Accrual And Real Earnings Management in Indonesia

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Abstract: *There are two perspectives why managers do earnings management, namely opportunistic and efficient perspective. The purpose of this research was to test the perspective of accrual earnings management and real earnings management in Indonesia. Perspectives of earnings management were measured by future profitability, that consisted of three proxies, namely future earnings changes (ΔNI_{t+1}), future cash flow from future operation (CFO_{t+1}), and future nondiscretionary income ($NDNI_{t+1}$). The result showed accrual earnings management and real earnings management had non significant impact on future earnings changes, future cash flow from future operation, and future nondiscretionary income, meant managers in Indonesia tend to execute opportunistic accrual and real earnings management.*

Keywords: *Accrual Earnings Management, Real Earnings Management, Opportunistic Perspective, Efficient Perspective.*

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I. Introduction

For most investor, earnings is considered critical information in making investment decision. Unfortunately, this information is oftenly mislead by manager for their personal welfare by executing earnings management (Graham et al., 2005). Healy and Wahlen (1998) explain earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial report to either mislead stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. Healy and Wahlen (1998) proposed definition that not much different from Weil (2009). Weil (2009) explains earnings management occurs when firm management has the opportunity to make accounting decisions that change reported income and exploit those opportunities.

The practice of earnings management can be seen from two underlying perspectives. Scott (2009) mentions two main characteristics or perspectives why managers execute earnings management, namely opportunistic perspective and efficient perspective. The first is executed by managers with aim to maximize his personal welfare. Christie and Zimmerman (1994) explain that in efficient perspective, management performs to increase all parties' wealth involved in contract. Based on research by Christie and Zimmerman (1994), Subramanyam (1996), it was interesting to test the perspective of earnings management in Indonesia. By knowing perspective earnings management it can be revealed the reasons managers execute earnings management. Therefore, this research proposed questions whether the practice of accrual earnings management and real earnings management were motivated by opportunistic perspective. The aims of this research is give empirical evidence the practice of accrual earnings management and real earnings Management are motivated by opportunistic perspective.

II. Literature Review And Hypothesis Development

2.1. Earnings Management

Gap information (information asymmetry) held by both managers and stakeholders encourage managers to behave opportunistically in revealing financial information. Managers will only reveal some information if they get benefit from it. Information asymmetry between managers and stakeholders provides an opportunity for managers to manage earnings.

Scott (2009) defines earnings management as an act of selecting accounting policies from a set of accepted accounting rules to get favorable results. Similar with Scott's (2009) opinion, Roychowdhury (2006) and Gajevszky (2014) explain earnings management can be defined as modification of accounting figures as an outcome of ordinary operational practices appears to arise from management's motivation, the aim is to mislead shareholders to ensure that the organization's financial targets have been met in the course of Business. So, Earnings management can be concluded as a creative way based on PABU (Indonesian GAAP) to use different accounting techniques to make financial statements look better, especially earnings.

Roychowdhury (2006) classifies earnings management into two categories, namely accrual earnings management and real activities manipulation (real earnings management). Accrual earnings management can be done through accrual manipulation, managers manipulate the discretionary accrual which has no effect or consequence to the cash flows directly.

The second method of earning management is real earnings management. Kothari, et al (2012) explains that managers prefer to use real earnings management because it is more difficult for auditors and regulators to detect whether it is the action of companies' strategy or indeed manipulation. Managers' strategy to do real earnings management is through the manipulation of the daily activities of the company during the current accounting period, which ultimately affects cash flows. Managers' techniques to do real earnings management are purposely reduce discretionary expense, sales manipulation in order to meet sales volume target by offering massive discount, and overproduction.

2.2. Perspective of Earnings Management

Scott (2009) explains that there are two important perspectives why managers do earnings management, namely opportunistic and efficient perspective. Opportunistic earnings management perspective is earnings manipulation performed by managers by selecting certain accounting policies to maximize their own personal gain. Suwardjono (2006) emphasizes empirically that there are a lot of contracts in which contain clauses that require profit as an element of an agreement between managers and shareholders, such as profit-sharing, bonus debt contracts. The role of profits in various contracts also causes various behaviors for parties who fulfill the contract for the determination of earnings.Earnings management underlined by opportunistic behavior is something investors should be aware of because earnings management performed by managers to achieve present day's profits for some reason may result in low corporate profits in the future. Consequently, when investors make decisions on such informed profits, they may make wrong investment decisions.There are two conditions that allow managers' opportunistic behavior, the first is a change in the condition of the company like weak oversight system that allows managers to enrich themselves. The second condition is an error in the initial agreement. Subramanyam (1996) research on the perspective of earnings management finds new evidence that managers in the United States use their discretion authority to improve the quality of financial information that communicated through profit figures. This is called efficient perspective. Christie and Zimmerman (1994) explain that the efficient perspective management acts to increase the wealth of all parties involved in the contract.

Cohen et al., (2008) prove that there was an increase in earnings management practices throughout the period of study in the United States from 1987 to 2005. Earnings management is done to achieve even surpass the previous earnings, meet analysts' earnings forecasts and avoid reporting income losses. Three reasons to perform earnings management done by managers are because of managers wanting their performance well assessed. If the managers' performance is good, then their position will be maintained. However, if they show poor performance, the managers will be fired.The researcher concluded that managers in Indonesia tend to execute opportunistic earnings management. It was because if they prefer efficient earnings management that has implication on future profitability, it is worried that in the future he is no longer on same position as he does now. If the perspective of earnings management is efficient, both accrual earnings management and real earnings management will have significantly positive relationship with future profitability. But if it is opportunistic, it has significantly negative relationship or insignificantly relationship with future profitability (Subramanyam, 1996). Thus the hypothesis was:

H1a: Accrual earnings management doesn't have effect on future profitability
H1b: Real earnings management doesn't have effect on future profitability

III. Research Method

3.1. Research Population dan Sample

The sample includes all companies listed on the Indonesia Stock Exchange (IDX) except for companies in financial services, real estate industries, hotel, transportation, and travel for the period from 1991 to 2015. The observation period was from 1993 to 2014, and used purposive sampling method. Financial statement data were obtained from websites of the Indonesia Stock Exchange, Center for Stock Market Data of Economics and Business Faculty of Gadjah Mada University in Yogyakarta, Economics Faculty of the Islamic University of Indonesia in Yogyakarta, and Faculty of Economics University of Atma Jaya Yogyakarta.

3.2.Definition and Variables Measurement

1. Perspective of Earnings Management

Subramanyan (1996) used three proxies of future profitability, namely :

1. CFO_{t+1} = Cash flow from operation activities at period t+1
2. NDNI $_{t+1}$ = Non discretionary income at period t+1 (NI – DA)

3. ΔNI_{t+1} = The change of future earnings ($NI_{t+1} - NI_t$)
   All variables are divided by early year total assets (TA_{it})
2. Accrual Earnings Management

Proxy of accrual earnings management is discretionary accruals. Based on model developed by Jones in 1991 as in Cohen et. al., (2008), the discretionary accruals is calculated by regressing the following equation

$$TACC_{it} = \beta_0 + \beta_1 \frac{1}{TA_{it}} + \beta_2(\Delta SALE_{it} - \Delta AR_{it}) + \beta_3 PPE_{it} + \varepsilon_{it}$$

Note:

$TACC_{it}$ = companies' total accrual i in time t

TA_{it} = companies' average total asset i in time t

$\Delta SALE_{it}$ = changing of company sales i in time t

ΔAR_{it} = changing of credit i in time t

PPE_{it} = fixed asset before decreased by depression (*gross property,plant, and equipment*) i in time t.

All variables is devided by average total asset.

The value of discretionary accruals in this study is absolute (ABS_DA).

3. Real Earnings Management

Roychowdhury (2006) explains real earnings management was proxied by cash flow from operations (RM_CFO), abnormal discretionary cost (RM_DISX), and abnormal production cost (RM_PROD).

a. Cash flow from operations (RM_CFO):

Regression model for normal cash flow from operation is follow

$$\frac{CFO\ it}{Assets\ i,t-1} = k1t\frac{1}{Assets\ i,t-1} + k2\frac{Sales\ it}{Assets\ i,t-1} + k3\frac{\Delta Sales\ it}{Assets\ i,t-1} + \varepsilon\ it$$

Abnormal CFO (RM_CFO) is calculated by subtracting actual CFO with normal level CFO. Then, value of RM_CFO is multiplied by -1.

b. Abnormal discretionary cost (RM_DISX):

Model of normal level of discretionary expenses is as follow :

$$\frac{DiscExp\ it}{Assets\ i,t-1} = k1t\frac{1}{Assets\ i,t-1} + k2\frac{Sales\ it-1}{Assets\ i,t-1} + \varepsilon\ it$$

Abnormal Discretionary Expenses (RM_DISX) = actual DISX – normal level DISX.
Then, Value of RM_DISX is multiplied by -1.

c. Abnormal production cost (RM_PROD):

Regression model to estimate normal level COGS is :

$$\frac{COGS\ it}{Assets\ i,t-1} = k1t\frac{1}{Assets\ i,t-1} + k2\frac{Sales\ it}{Assets\ i,t-1} + \varepsilon\ it \text{...... (1)}$$

Regression model to estimate normal level of inventory growth:

$$\frac{\Delta INV\ it}{Assets\ i,t-1} = k1t\frac{1}{Assets\ i,t-1} + k2\frac{Sales\ it}{Assets\ i,t-1} + k3\frac{\Delta Sales\ it}{Assets\ i,t-1} + \varepsilon\ it \text{........(2)}$$

From equation (1) and (2) it can be estimated normal level of production cost. Regression model to estimate normal production cost level is as follow :

$$\frac{Prod\ it}{Assets\ i,t-1} = k1t\frac{1}{Assets\ i,t-1} + k2\frac{Sales\ it}{Assets\ i,t-1} + k3\frac{\Delta Sales\ it}{Assets\ i,t-1} + k4\frac{\Delta Sales\ it-1}{Assets\ i,t-1}\ \varepsilon\ it$$

Abnormal production costs (RM_PROD) = Actual PROD – Normal level PROD.

Real earnings management (RM_PROXY) is calculated by totaling up standardized values from cash flow from operations (RM_CFO), abnormal discretionary cost (RM_DISX), and abnormal production cost (RM_PROD).

4. Control Variables

Three control variables used in this research:

1. Firm size (Ln_Assets) = natural log of company's assets value at year end,
2. Leverage (Lev) = total debt / total assets
3. Growth of sales (GSales) = change of sales / total assets at early year

3.3. Research Model
Research model was using multiple regression method:
$FP = \alpha + k_1\ ABS\_DA + k_2\ RM\_PROXY + k_3\ Ln\_Assets + k_4\ LEV + k_5\ GSales + \varepsilon$
Note :
FP = Future Profitability
ABS_DA = Accrual earnings management
RM_PROXY = Real earnings management
Ln Assets = Natural logarithm firm size
Lev = Leverage
GSales = Growth of sales
A = Constanta
k = Regression coefficient
ε = *Error*

Coefficient of accrual earnings management and real earnings management were variables to be observed in assessing perspective of earnings management. If accrual earnings management (k1) and real earnings management (k2) were both positive, then the perspective of earnings management was efficient. But if both were negative or insignificant, the perspective was opportunistic (Subramanyam, 1996).

IV. Result And Discussion

The number of companies sampled in this study was 31 (thirty one) companies and period of research over twenty two (22) years. To conclude perspective of opportunistic earnings management, accrual earnings management (ABS_DA) and real earnings management (RM_PROXY) must have significant negative relationship or insignificant relationship with proxies of future profitability (Subramanyam, 1996). Proxies of future profitability are ΔNI_{t+1}, CFO_{t+1}, $NDNI_{t+1}$.

Table 1 Result of Regression Analysis
$FP = \alpha + k_1\ ABS\_DA + k_2\ RM\_PROXY + k_3\ \textit{Ln\_Assets} + k_4\ Lev + k_5\ GSales + \varepsilon$

Variabel	ΔNI_{t+1}		CFO_{t+1}		$NDNI_{t+1}$	
	t-statistic	*p-value*	*t-statistic*	*p-value*	*t-statistic*	*p-value*
ABS_DA	1.679	.094	-.009	.993	-.730	.466
RM_PROXY	-.372	.710	.456	.649	.174	.862
ln_Assets	-1.277	.202	.051	.960	1.138	.255
Lev	2.232	.026	-1.778	.076	-1.735	.083
GSales	1.244	.662	.438	.662	-.902	.368

(significant level at 5%)

Based on Table 1, regression analysis shows that variables of accrual earnings management (ABS_DA) and real earnings management (RM_PROXY) has insignificant impact on all three of future profitability, ΔNI_{t+1} with p-value 0,094 and 0,710, CFO_{t+1} with p-value 0,993 and 0,649, $NDNI_{t+1}$ with p-value 0,466 and 0,862, meaning that it's bigger than 0,05. It means statistically accrual earnings management and real earnings management don't have effect on future profitability, thus leads to conclusion that the accrual earnings management and real earnings management have opportunistic perspective. Based on result of regression analysis, it can be drawn conclusion that empirical evidence supported the hypothesis.

V. Conclusion

This research was succeed to prove that perspective of accrual earnings management and real earnings management in Indonesia were both opportunistic. This result proves that managers in Indonesia tends to maximize their personal welfare than of all parties involved in contract. The results of this study can be used as an input for both investors and auditors to be aware of earnings management practices. Earnings management practices need to be considered by investors in making investment decisions. The results of this study prove that earnings management perspective conducted by managers are opportunists. Investors should be aware of managers' opportunistic perspective because earnings management conducted by managers to achieve present day's profits may result in low corporate profits in the future. Consequently, when investors make decisions based on such informed profits, they may make wrong investment decisions.

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