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The Effect of Real Activities Manipulation on Accrual Earnings Management: The Case in Indonesia Stock Exchange (IDX)

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There are three ways to manage earnings, namely, accruals earnings management, real activities manipulation, and shifting of core expense. The famous methods to manage earnings are accruals earnings management and real activities manipulation. Usually, real activities manipulation is conducted on the going period. The action will increase the loss for the firms at the end of the period. To avoid the loss, managers will manage earnings through accruals (discretionary accruals). Therefore, the objective of this study is to investigate whether real activities manipulation positively influences accruals earnings management. To investigate the issue, this study collected data from Indonesia Stock Exchange (IDX). Samples of this study are the manufacturing companies. There are 196 firms from the year 2003 to 2007. The results of this study support the research hypothesis that real activities manipulation positively influences accruals earnings management. The higher the real activities manipulation effects, the higher the accruals earnings management at the end of the period.

Keywords: earnings management, real activities manipulation, accruals earnings management

Introduction

Earnings management has become a common phenomenon occurring in various countries including Indonesia. One interesting phenomenon in Indonesia is the case about Kimia Farma's inflating profits made by the management of PT Kimia Farma Tbk in a financial statement in the fiscal year 2001. This markup was known in the year 2002. This condition was first discovered by public accountants Hans Tuanakotta and Mustofa. The management made irregularities in the financial statements in the first half of 2001. The value of inflating profit is Rp32.7 billion. The profits should be Rp99.6 billion, while the reported earnings are Rp132.3 billion with the net sales of Rp1.42 trillion.

This phenomenon indicates that manipulation of the financial statement is still possible to be conducted by managers. Following the definition of Healy and Wahlen (1999), earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence the contractual outcomes that depend on reported accounting numbers.

According to Hendriksen and Breda (1992), earnings are considered as a measurement of efficiency. The efficient operation of an enterprise affects both the current dividend stream and the use of the invested capital for providing a future dividend stream. Therefore, all equity holders are interested in the efficiency of

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management. The present equity holders can take the necessary steps to obtain a new management, if the present management is not operated efficiently. They may also provide incentives or bonuses to efficient managements. Prospective stockholders will attempt to evaluate the efficiency of management before investing or placing a value on the stock of the firm. A measurement of the efficiency of the firm provides a basis for decisions. Therefore, earnings will be managed by managers to inform the outside investor that the firm's performance is good.

Earnings are managed by managers, because they are very important information for the internal and external users. Earnings management does not violate the existing regulations and the generally accepted accounting principles. However, earnings management can be detrimental to the information of financial statements. Earnings are managed by managers through accruals, real activities, and shifting of core expense. Usually, real activities manipulation is conducted on the going period. Roychowdhury (2006) defined real activities manipulation as differences in the activities of normal operational. Manipulation of real activities can be most extensively achieved through price discounts and can reduce discretionary expenses to meet earnings targets.

According to Davidson, Stickney, and Weil (1987), earnings management is a process of taking deliberate steps within the constraints of generally accepted accounting principles desired to bring about a level of reported earnings. Based on this definition, Sugiri (1999) concluded that management could play a role in accrual components. Earnings management in this narrow sense is the behavior of management to play with the discretionary accrual component to determine high or low earnings. Earnings are potentially managed, because financial accounting standards still provide alternative method.

Accruals are a tool to manage earnings at the end of the period. Real activities manipulation, on the other hand, is a tool to manage earnings on the going period. Accruals may be chosen to avoid loss affected by real activities. Therefore, this study investigates whether accrual manipulation of real activities (accounting) influences earnings management.

The rest of this paper is organized as follows: Section 2 presents theoretical and hypothesis development. Section 3 discusses research methods. Section 4 reports the empirical results. Section 5 concludes the result of this research.

Hypothesis Development

Positive Accounting Theory and Earnings Management

Positive accounting theory is based on agency theory, which is used to explain and predict accounting choices by managers. Opportunities for the contracting parties can influence accounting choices, because accounting numbers are a control mechanism in the agency relationship. Watts and Zimmerman (1986) applied agency theory to explain and predict the behavior of management related to the selection of accounting procedures. Watts and Zimmerman (1986) explained three hypotheses, namely, bonus plan, debt covenant, and political cost.

(1) Bonus plan hypothesis: Ceteris paribus, managers of firms with the bonus plans are more likely to choose accounting procedures that shift reported earnings from the future period to the current period.

The parameters of bonus plans set as bonuses are awarded in most years. If a bonus can be awarded, the maximum amount is a positive linear function of reported earnings. This makes it possible that manager's compensation under a bonus plan increases as reported earnings increase.

(2) Debt/equity hypothesis: Ceteris paribus, the larger a firm's debt/equity ratio, the more likely the firm's manager will select accounting procedures that shift reported earnings from the future period to the current period.

The debt/equity hypothesis can be derived from the hypothesis based on the debt covenants that, the closer a firm is to a particularly restrictive accounting-based covenant, the more likely the manager will use procedures that increase current earnings.

(3) Size hypothesis: Ceteris paribus, the larger the firm, the more likely the manager will choose accounting procedures that defer reported earnings from the current period to the future period.

Accounting researcher has used firm size as a proxy for a firm's political sensitivity, and thus, the incentive of managers to choose earnings has reduced accounting procedures. The hypothesis is based on the assumption that larger firms are more politically sensitive and have relatively larger wealth transfers imposed on them than smaller firms.

Earnings Management by Discretionary Accruals

Accruals earnings management is a tool to manage earnings through the choice of accounting methods adopted by the generally accepted accounting principles. Motivation of managers to manage earnings (Healy & Wahlen, 1999; Scott, 2006) is empirically provided by several researchers. Motivation bonuses are empirically provided by Healy (1985), Gaver, Kenneth, and Jeffrey (1995), Holthausen, David, and Richard (1995), and Guidry, Andrew, and Steve (1999). Another contractual motivation is provided by Sweeney (1994) and DeFond and Jiambalvo (1994). Political motivation is provided by Jones (1991), Cahan (1992), Na'im and Hartono (1996), Key (1997), and Navissi (1999). Dopuch and Pincus (1988) provided the tax motivations. Chief executive officer (CEO) turnover is empirically provided by DeFond and Park (1997). Capital market motivations is empirically provided by Perry and Williams (1994), Teoh, Welch, and Wong (1998a, 1998b), Rangan (1998), and Erickson and Wang (1999). In these studies, the accruals method is selected by managers to manage earnings.

Many researchers in Indonesia use discretionary accruals as proxy for earnings management, as shown in studies by Gumanti (2001), Saiful (2004), Meutia (2004), Sukartha (2007), Rahmawati, Suparno, and Qomariyah (2007), Sanjaya (2008), and Joni and Jogiyanto (2009). Saiful (2004) examined the relationship between earnings management with the operating performance and stock returns around the initial public offering (IPO). He used discretionary accruals as proxy for earnings management and found that earnings management around the IPO occurred two years before the IPO, two years during the IPO, and two years after the IPO. He also found that the company's operating performance after the IPO was low. The low performance is affected by the earnings management. This is shown by a low stock return one year after the IPO.

Meutia (2004) examined the effects of independent auditor against earnings management for the auditor Big 5 and Non-Big 5. He used discretionary accruals as proxy for earnings management and found that there was a negative relationship between audit quality and earnings management. It indicates that auditor Big 5 has a lower absolute value of discretionary accruals than Non-Big 5 companies.

Gumanti (2001) examined the earnings management in IPO on the Indonesia Stock Exchange (IDX). He used discretionary accruals as proxy for earnings management and found that earnings management occurred two years before going public. It means that issuers have chosen accounting methods that have increased reported earnings on the prospectus financial statements via income-increasing discretionary accruals.

Sukartha (2007) conducted a study about the effect of earnings management, managerial ownership, and firm size in the target firm. He used discretionary accruals as proxy for earnings management and found that the company's acquisition targeted to manage earnings by increasing the value of discretionary accruals, when the last publication happened before the acquisition. Earnings management positively influenced welfare of the target.

Rahmawati et al. (2007) examined the effects of information asymmetry on earnings management in banking company listed on the Jakarta Stock Exchange. They used discretionary accruals as proxy for earnings management and found the positive effect of information asymmetry on the earnings management.

Sanjaya (2008) conducted a study about the influence of the external auditors and the audit committee on earnings management. He used discretionary accruals as proxy for earnings management and found that external auditors affected earnings management. Meanwhile, the audit committee did not affect earnings management.

Joni and Jogiyanto (2009) examined the relationship between earnings management before the IPO and the stock return with sophisticated investor as a moderating variable. They used discretionary accruals as proxy for earnings management and found that there was a relationship between earnings management and stock returns for less sophisticated investors. This suggests that high earnings management will cause a low value of the stock price, when considering the sophisticated investor.

Sanjaya (2011) also used discretionary accruals as a proxy for earnings management. He examined the influence of an ultimate ownership on earnings management in Indonesia. The results are that the cash flow right leverage of the ultimate ownership positively affects the earnings management.

Earnings Management by Real Activities Manipulation

Real activities manipulation is a tool to manage earnings through the choice of changing the time or the structure of an operating, investing, and/or financial transaction to affect output accounting system. Managers also have opportunity to manage earnings by manipulation of real activities. Manipulation of real activities decreases the amount of research and development costs as one way to affect the cash flow and accruals (Baber, Fairfield, & Haggard, 1991; Dechow & Sloan, 1991; Bartov, 1993; Bushee, 1998; Bens, Nagar, & Wong, 2002; Bens, Nagar, Skinner, & Wong, 2003). Healy and Wahlen (1999), Fudenberg and Tirole (1995), and Dechow and Skinner (2000) focused on accelerating sales, delivering schedule, delaying research and development activities, and restricting spending as earnings management methods. They are available for managers to manipulate the real activities.

Roychowdhury (2006) defined real activities manipulation as differences in normal activities. Manipulation of real activities can be most extensively carried out through price discounts and can reduce discretionary expenses to meet earnings targets. The survey results of the studies by Bruns and Merchant (1990) and Graham, Harvey, and Rajgopal (2005) indicate that financial executives are more interested in manipulating earnings through real activities than through accruals to meet earnings targets. This has happened because of the following reasons: Firstly, the manipulation of accruals tends to attract an auditor or a regulator more to supervise than a real decision does. Secondly, compared with the manipulation of real activities, accrual manipulation causes more risks.

In Indonesia, studies of earnings management using real activity manipulation are limited. Oktarina and Hutagaol (2009) analyzed cash flow operation activities in detecting manipulation of real activity and its

impact on market performance. They used the cash flow activity to detect abnormal operations of real activities, and found that companies manipulated real activity by operating cash flow that had impact on market performance.

Manipulation of real activities can reduce the value of the company, because the activities have a negative effect on cash flow in the next period. Aggressive price discounts not only have increased sales volumes, but have also caused the customers to expect a discount in future period. This has led to the lower sales margins. Increase in volume has also caused an excessive production (overproduction). The result is that there is an excess supply that must be sold in the subsequent period. This inevitably causes greater holding cost of inventory.

Real activities manipulation and accruals earnings management have different characteristics. Accruals earnings management does not affect the cash flows directly. Real activities manipulation, on the other hand, has influence on the high cost of cash flow. However, it does not restrict managers to use continually real activities manipulation to manage earnings. According to Roychowdhury (2006), managers do not prefer to use only accrual earnings management to manage earnings. Auditors know the accruals easily. Therefore, the accruals are riskier, if managers use only accruals to manage earnings. Earnings must be managed to meet the level of desired earnings. This condition encourages managers to manage earnings thought real activities manipulation and accruals earnings management. They are complementary to manage earnings.

Generally, managers determine the level of accruals earnings management after determining the level of real activities manipulation (Matsuura, 2008). Real activities manipulation is conducted during that period. Accruals earnings management, on the other hand, is conducted at the end of the period. This characteristic encourages managers to manage earnings through real activities manipulation and accruals earnings management, both of which are complementary to manage earnings, in order to achieve threshold earnings. Real activities manipulation and accruals earnings management are also conducted to make stable earnings. For example, PT ABC has a negative income (which is actually smaller than expected earnings). Managers will increase earnings to meet the expected earnings. The strategy is conducted to increase the sales by providing limited discount. The discount is one of the real activities manipulation techniques. Discounts will encourage consumers to buy firm's products, and total sales will increase too.

However, PT ABC cannot continue to give discounts. After meeting the expected level of earnings, the discounts will not continue, because the discounts will cause the loss of PT ABC. In addition, the granting of discounts in one year can also reduce consumer's image from time to time. The consumers will consider the bad quality of the products. When the discount is stopped, the firm's profit will decline, and managers of PT ABC will try to raise the profit levels. Therefore, at the end of the year, managers will use other methods to increase profit. That is accruals earnings management. Managers reduce bad debt to maintain levels of earnings consistently. In the end, the sum of earnings is the same as the sum of expected earnings.

Based on the example, managers use real activities manipulation and accruals earnings management to manage earnings. They first use real activities manipulation and then use the accruals earnings management to manage earnings, both of which are used sequentially. Real activities manipulation encourages managers to conduct accruals earnings management. This study expects that real activities manipulation positively influences accrual earnings management. Therefore, the authors hypothesize as follow:

H1: Real activities manipulation positively influences accruals earnings management.

Research Method

Data

The 49 samples are collected by a purposive sampling. The criterions are as follows:

(1) The manufacturing companies are listed at IDX from the January 1st, 2003 to December 31, 2007. They have to publish the financial reporting from 2003 to 2007;

(2) The companies have data completely on a financial statement;

(3) The companies have 12-month accounting periods.

Type of data in this study is the secondary data. Data are collected from database of the IDX from 2003 to 2007 and the Indonesian Capital Market Directory (ICMD).

Definition and Measurement Variables

Real activities manipulation is indicated by discretional cash flow operating activities. Examples of operating cash flow are interests and tax payment receipts. Discretional cash flow operating activities are carried out to catch the real activities of managers to manage earnings. The researchers calculated that real activities manipulation was the discretional cash flow from operating activities as shown in a residual model of Roychowdhury (2006). The formula is as follow:

$$CFO_{it} = a_0 + a_1 SALE_{it} + a_2 \Delta SALE_{it} + \varepsilon_{it} \quad (1)$$

where:

CFO: Cash flows from operating activities, which are divided by total assets at the beginning of the period;

SALE: Sales of that year, which are divided by total assets at the beginning period;

Δ*SALE*: Changes in annual sales, which are divided by total assets at the beginning period;

ε: Regression residual (a proxy for real activities manipulation).

Accruals earnings management is indicated by discretional accruals. Discretional accruals are calculated by using Jones' (1991) model. This model is widely used in these studies, because the estimation of discretional accounting accruals also includes the amount of non-discretional accruals. This study measures the discretional accruals (proxy for accruals earnings management) as a residual model of Jones. The formula is as follow:

$$TACC_{it} = b_0 + b_1 PPE_{it} + b_2 \Delta SALE_{it} + \zeta_{it} \quad (2)$$

where:

TACC: Total accruals, which are different from cash flows of operating activities with the net profit after tax, are divided by total assets at the beginning period;

PPE: Gross property, plant, and equipment at the beginning period, which are divided by total asset at the beginning period;

Δ*SALE*: Changes in annual sales, which are divided by total assets at the beginning period;

ζ: Regression residual (a proxy for accruals earnings management).

This study uses three control variables, namely, leverage, size, and firm's growth. Control variables were used to control the causal relationship in the model, in order to get a more complete empirical model (Jogiyanto, 2010). The argument of this study uses three control variables, which are related to the positive accounting theory. The theory suggests three motivations to manage earnings. Namely, debt covenant hypothesis (leverage), political cost hypothesis (size), and bonus plan hypothesis (firm's growth).

(1) Debt to equity ratio is the ratio of debt to equity at the end of the year;

(2) Firm's size is the natural logarithm of total assets at end of the period;

(3) Firm's growth is the change in sales.

Generally, real activities manipulation occurs before accruals earnings management. Therefore, this study determines unexpected income *PreAEMUI* before accruals earnings management (Matsuura, 2008). *PreAEMUI* is the unexpected income before accruals earnings management.

$$PreAEMUI_{it} = UI_{it} - AEM_{it} \tag{3}$$

Next, in order to test the hypothesis, an empirical model is presented as follow:

$$AEM_{it} = \delta_0 + \delta_1 PreAEMUI_{it} + \delta_2 RAM_{it} + \delta_3 LEV_{it} + \delta_4 SZ_{it} + \delta_5 GROWTH_{it} + \psi_{it} \tag{4}$$

where:

AEM: Accruals earnings management;

PreAEMUI : Unexpected income before accruals earnings management;

RAM: Real activities manipulation;

LEV: Leverage;

SZ: Size;

GROWTH: Firm's growth;

ψ: Residual error.

Empirical Results

Descriptive Statistics

The results of Table 1 show that the minimum value of *RAM* is -0.38, and the maximum value is 0.33. This result indicates that, there are companies which increase and decrease earnings through a real activity manipulation. *AEM* variable has the minimum value and the maximum value of -0.31 and 0.33 respectively. The result also indicates that, there are companies which increase and decrease earnings through discretionary accruals.

Table 1

Descriptive Statistics

Variable	No.	Minimum	Maximum	Mean	Standard deviation
AEM	196	-0.31	0.33	0.0000	0.08670
PreAEMUI	196	-5.58	3.86	0.0886	0.93174
RAM	196	-0.38	0.33	0.0000	0.10607
LEV	196	0.05	10.93	1.0765	1.08627
SZ	196	24.05	31.78	27.5615	1.54517
GROWTH	196	-1.00	1.47	0.1693	0.23451

The minimum value of *PreAEMUI* is -5.58 and the maximum value is 3.86. The mean value of *PreAEMUI* is 0.0886 and the standard deviation is 0.93174. The minimum value of *LEV* is 0.05 and the maximum value is 10.93. The mean of *LEV* is 1.0765 and the standard deviation is 1.08627. The minimum value of *SZ* is 24.05 and the maximum value is 31.78. The mean value of *SZ* is 27.56515, and the standard deviation is 1.54517. The minimum value of *GROWTH* is -1.00 and the maximum value is 1.47. The mean value of *GROWTH* is 0.1693 and the standard deviation is 0.23451.

Based on the results in Table 2, real activities manipulation positively influences accruals earnings management. Therefore, H1 is supported. The results support the findings of Matsuura (2008). Real activities manipulation occurs when managers change the time or the structure of operating, investing, and financial transactions to affect the output accounting system. The real activities manipulation is chosen to manage earnings throughout the running period. If managers conduct real activities manipulation to manage earnings at the end of the period, it will be a serious problem for them, because it has influences on the cash flow.

Table 2

The Results of Analysis of Equation (4)

Variable	Coefficient	*t*-statistic
Constant	-0.079	-0.719
PreAEMUI	-0.015	-2.239**
RAM	0.223	3.950***
LEV	-0.009	-1.547
SZ	0.003	0.759
GROWTH	0.037	1.417
Adjusted R^2	0.102	
F-statistic	5.424	
Probability of *F*-statistic	0.0000	
No.	196	

Note. ***, ** indicate statistic is significant at the alpha 1% and 5% respectively.

Accruals earnings management is chosen to manage earnings by selecting accounting methods accepted by Generally Accepted Accounting Principles (GAAP). Changes in accounting method are generally conducted at the end of the period. Therefore, the manager determines the level of accrual earnings management after real activities manipulation.

Conclusions

Based on the results, it is proved that real activities manipulation positively influences accruals earnings management. The results suggest that the increase of real activities manipulation affects the increasing accruals earnings management. Limitation of this research is that real activities manipulation is only measured by cash flow from operating activities. Subsequent researchers can use other proxies of real activities manipulation.

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