

Real Earnings Management Practices in Indonesia: Opportunist or Efficient Earnings Management Practices?

Anselmus Yovi Agung Brahmono
Universitas Atma Jaya Yogyakarta

Anna Purwaningsih*
Universitas Atma Jaya Yogyakarta

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ABSTRACT

This study re-examines earnings management practices in Indonesia because the results of previous studies have shown inconsistent results. This study aims to obtain empirical evidence regarding whether earnings management practices in Indonesia are efficient or opportunistic earnings management practices. Efficient earnings management practices will have a positive effect on future company performance. On the other hand, opportunistic earnings management practices will negatively affect the company's future performance. The sample of this study is manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the period 2011-2020. The dependent variable is the company's performance, which is proxied by return on assets (ROA). The independent variable is real earnings management. The control variables are company size, affiliation of public accounting firm, and company growth. Hypothesis testing uses multiple regression tests. The test results show that earnings management practices have a negative effect on company performance. Thus, this research concludes that the practice of earnings management in Indonesia is opportunistic.

Keywords: company performance, earnings management, real earnings management, opportunistic earnings management

1. INTRODUCTION

This study aims to obtain empirical evidence regarding whether earnings management practices in Indonesia are opportunistic or efficient. The results of this study are expected to assist investors in making investment decisions and assist regulators in developing regulations related to tax management practices on the Indonesia Stock Exchange (IDX). The sample of this research is manufacturing companies listed on the IDX 2011-2019.

Earnings management is when a manager's intervention into the company's financial statements has an impact on company performance (Rankin *et al.*, 2012; Wardani & Kusuma, 2012). Many researchers see earnings management as being an opportunistic practice (Roychowdhury, 2006; Wardani & Kusuma, 2012; Tabassum, Kaleem & Nazir, 2015). Opportunistic earnings management is earnings management carried out by managers only to fulfill their personal interests (Wardani & Kusuma, 2012; Tabassum, Kaleem & Nazir, 2015). Earnings management tends to produce good

earnings reporting so that management gets benefits in the form of bonuses as the feedback of manager's performance in running the company's operations. Opportunistic earnings management has a positive impact on the company's performance in the short term, but has a negative impact in the long term, such as a decrease in company value and the company's future performance (Roychowdhury, 2006; Amin, Lukviarman & Setiany, 2018;).

In addition to opportunistic earnings management, the results also show that earnings management is efficient (Siregar & Utama, 2008; Rezaei & Roshani, 2012; Paredes & Wheatley, 2017). The study states that earnings management is efficient and has a positive effect on the company's future performance. Efficient earnings management means that earnings management helps in increasing the earnings informativeness that is communicated to investors (Siregar & Utama, 2008; Rezaei & Roshani, 2012). Paredes & Wheatley (2017) mention that earnings management is "just business" to increase future return on assets, future return on sales, and security returns. The differences in the results of previous studies encourage researchers to conduct further research related to earnings management, namely whether earnings management practices in Indonesia are opportunistic business practices or efficient business practices.

Previous research in Indonesia has provided different results (Siregar & Utama, 2008; Wardani & Kusuma, 2012). Wardani & Kusuma (2012) state that earnings management practices in Indonesia are opportunist. However, Siregar & Utama (2008) state the opposite: that the practices are efficient. There are differences between the results of previous studies related to the nature of earnings management in Indonesia, so companies listed on the IDX are the focus of this research.

Earnings management in this study uses real earnings management techniques, which are proxied in the Roychowdhury (2006) model. Real earnings management is used in this study because such practices are more common than accrual earnings management practices in Indonesia (Purwaningsih & Kusuma, 2020).

2. HYPOTHESIS DEVELOPMENT

Managers have access to more company information than investors. Specific information such as future performance, company strategy, changes in company characteristics, and market conditions are known to managers. This special information cannot be communicated to investors, resulting in information asymmetry (Lisa, 2012).

Real earnings management has an impact on the future performance of the company. Real earnings management can generate good earnings this year, but in the long run it will hurt the company because of declining performance in the future (Roychowdhury, 2006). There are several reasons for this (Roychowdhury, 2006). First,

manipulation of sales with discounts results in low future cash flows because sales volume decreases when prices are normal because consumers expect to receive the discounts in the future. Second, manipulation of sales with lighter credit terms results in low cash flow; for example, companies providing low interest rates results in low cash inflows. Third, excess production results in lower fixed costs per unit because increased production causes fixed overhead costs to be spread over more product units. By reducing the fixed cost per unit, the total cost per unit becomes lower. However, overproduction also results in higher production costs and inventory holding costs. Fourth, cutting discretionary costs results in lower cash flows and future earnings due to the weakening of the company's competitiveness.

Management performs earnings management with the intention of maximizing its utility (Tabassum et al., 2015; Wardani & Kusuma, 2012; Siregar & Utama, 2008). In order to maximize utility, managers tend to act in their own interests. Managers' satisfaction increases when they receive bonuses. Shareholders provide feedback such as incentives and bonuses for the performance of managers in carrying out company operations. Managers are usually judged based on the achievement of operating profits (earnings), so managers are motivated to carry out earnings management to get the maximum bonus. This statement is equivalent to agency theory which says that self-satisfaction drives managers to engage in earnings management. Earnings management with such intent is an example of opportunistic earnings management which usually has a negative effect on future company performance. Several studies have demonstrated the negative influence of earnings management on the future performance of companies in Indonesia (Tabassum et al., 2015; Wardani & Kusuma, 2012).

On the other hand, real earnings management can also be efficient, namely when management can develop earnings informativeness to be communicated to investors (Gunny, 2010; Rankin et al., 2012; Wardani & Kusuma, 2012). Information asymmetry is caused by the existence of company information that cannot be conveyed publicly, such as future performance, company strategy, changes in company characteristics, and market conditions. However, Ronen and Yaari state that earnings management helps increase the transparency of the company's financial statements (Rankin *et al.*, 2012). The reported earnings are a signal for investors. Therefore, managers carry out earnings management to produce a good earnings report as a signal. The signal indicates that management can generate better earnings in the future (Gunny, 2010; Wardani & Kusuma, 2012). Paredes & Wheatley (2017) state that earnings management is "just business". This is caused by discretionary cost cutting which is carried out to increase company efficiency as a manager's response to low company performance. In addition, excessive production is carried out by managers based on the anticipation that, in the

future, sales will increase. Excessive production followed by positive sales growth indicates that managers use company resources efficiently (Paredes & Wheatley, 2017).

Earnings management also helps companies to achieve company earnings benchmarks (Gunny, 2010; Al-Shattarat, Hussainey & Al-Shattarat, 2018). Benchmark earnings have a positive effect on the company's performance in the future. Gunny (2010) also states that companies that carry out earnings management to achieve earnings benchmarks will do better in the future than those that do not. Real earnings management like this tends to have a positive effect on future company performance. Empirical studies demonstrate a positive relationship between earnings management and future performance (Al-Shattarat et al., 2018; Gunny, 2010; Paredes & Wheatley, 2017; Rezaei & Roshani, 2012; Wardani & Kusuma, 2012; Siregar & Utama, 2008).

The explanation above shows that earnings management can be either opportunistic or efficient. If earnings management is opportunistic, then earnings management will negatively affect the company's performance in the future. If earnings management is efficient, the effect of these practices on future performance will be positive. Thus, the impact of earnings management practices on future performance can be in two directions, namely positive or negative. Therefore, the following is the formulation of the research hypothesis.

H1. Earnings management has a negative effect on the company's future performance

H2. Earnings management practice in Indonesia is opportunistic.

3. RESEARCH METHOD

The sample of this study comprises manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the 2011-2019 period. The company's financial data have been obtained from the IDX website (www.idx.co.id) and IDN Financials (www.idnfinancials.com).

This study uses purposive sampling, with the following criteria: first, companies engaged in the manufacturing industry are selected. Manufacturing companies are most likely to have higher real earnings management than non-manufacturing companies (Roychowdhury, 2006). The second criterion is the availability of complete financial report data from 2009-2020.). The sample of this research consists of 139 companies (143 companies and trimming 3 companies).

The independent variable of this research is real earnings management (REM). Real earnings management is measured by using Roychowdhury's (2006) real earnings management index. The dependent variable is Return on Assets (ROA), which is a ratio that measures how effectively the company generates profits with its assets. Return on Assets has been widely used by previous researchers as a proxy for company

performance (Al-Shattarat et al., 2018; Dananti, Cahjono, & Mujiyono, 2017; Paredes & Wheatley, 2017; Ngamchom, 2015; Tabassum et al., 2015).

The control variables are firm size (FSIZE), audit firm (BIG4), and firm growth (GROWTH). Firm size is widely used by researchers as a control variable (Al-Shattarat et al., 2018; Rezaei & Roshani, 2012; Tabassum et al., 2015; Wardani & Kusuma, 2012; Siregar & Utama, 2008). There is a positive influence between the size of the company and profits from operating results, the larger the size of the company, the better the performance (Rudangga & Sudiarta, 2016; Ahmed Sheikh & Wang, 2013;). Firm size is measured using the natural logarithm of assets.

Companies with good audit quality usually create higher quality earnings reporting (Siregar & Utama, 2008) because auditors can limit management's opportunistic behavior (Siregar & Utama, 2008) so the company is able to operate and achieve better performance. High audit quality is proxied by the existence of audits conducted by affiliates of one of the world's top four public accountancy companies (BIG4). The BIG4 variable is measured by a dummy variable, assigned a value of 1 for companies audited by affiliates of the world's four major audit firms and 0 for others.

Firm growth is widely used by researchers as a control variable (Wardani & Kusuma, 2012; Tabassum, Kaleem & Nazir, 2015; Al-Shattarat, Hussainey & Al-Shattarat, 2018). Previous research has proven that company growth has a positive effect on company performance (Abughniem *et al.*, 2020). Company growth is measured by calculating the ratio of price to earnings.

3.2. Research Model

This study tested the hypothesis with the multiple regression method, with the following regression model:

$$ROA_{i,t+1} = a + b_1REM_{i,t} + b_2FSIZE_{i,t} + b_3BIG4_{i,t} + b_4GROWTH_{i,t} + e_{i,t}$$

Information:

ROA_{i,t+1} = Return on Assets at company i, in year t+1

REMI_{i,t} = Real earnings management in company i, in year t

FSIZE_{i,t} = Firm size in firm i, in year t

BIG4_{i,t} = audit company in firm i, year t; 1 if audited by Big 4 or 0 if others

GROWTH_{i,t} = Growth of firm i, in year t

a = constant value

b₁,b₂,b₃,b₄ = Regression coefficient value

e = Error

If real earnings management is efficient, then the coefficient value (b₁) is positive, on the other hand, if real earnings management is opportunistic, the coefficient value (b₁) is negative.

4. RESEARCH RESULTS AND DISCUSSION

4.1. Descriptive Statistics Test

The descriptive statistical test is carried out by looking at the amount of data, minimum value, maximum value, average value, and standard deviation value. The results of the research statistical tests are as follows:

Table 4. Statistics Descriptive

Variable	Observation	Minimum	Maximum	Mean	Stand.Deviation
ROA	1028	-0,0927	0,1577	0,030841	0,0513495
REM	1028	-8,5650	7,0730	0,284018	1,9282531
FSIZE	1028	25,1742	32,4945	28,414333	1,5729922
BIG4	1028	0	1	-	-
GROWTH	1028	-7375,0000	21500,0000	42,485208	737,1857176

4.2. Hypothesis testing

Before testing the hypothesis, the classical assumption test is performed first. The research data are normally distributed and have passed the classical assumption test, namely the multicollinearity, heteroscedasticity, and autocorrelation tests.

The results of hypothesis testing using the multiple regression method can be seen in Table 5.

Table 5. Hypothesis Testing

Variable	Coefficient	<i>P Value</i>
REM	-0,010	0,000***
FSIZE	0,003	0,002***
BIG4	0,006	0,061*
GROWTH	0.000	0,976

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 5 shows the results of the regression of the independent variables on the dependent variable. Based on the table, the following conclusion can be made: The REM variable has a negative coefficient value (-) and a p value of 0.000 which is smaller than 0.01, meaning that real earnings management has a significant negative effect on the company's future performance. Thus Hypothesis 1 is supported.

The REM coefficient (b) is negative. Thus, it can be said that the earnings management of manufacturing companies in Indonesia in the 2010-2019 period is opportunistic.

The FSIZE and BIG4 variables have significant positive effect on the future

performance of the company. The GROWTH variable has no effect on the company's future performance.

4.3. Discussion

Based on the results of the tests that have been carried out, it can be seen that real earnings management (REM) has a negative effect on a company's future performance. Thus hypothesis 1 is supported. Meanwhile, the REM coefficient is negative. This shows that the earnings management practices of manufacturing companies in Indonesia are opportunistic. Hypothesis 2 is supported.

Opportunistic earnings management is an earnings management practice that has a negative impact on the company's future performance. The results of this study are in line with the research of (Wardani & Kusuma, 2012) which states that earnings management in Indonesia is opportunistic and contradicts research (Siregar & Utama, 2008) which states that earnings management in Indonesia is efficient.

Earnings management practices in Indonesia are opportunistic, which means that managers act in their own interests, not in the interests of shareholders. Shareholders provide incentives and bonuses for the performance of managers in running the company's operations. Managers are assessed for their performance based on the achievement of company profits. Therefore, managers are motivated to carry out earnings management to get the maximum bonus. This statement is equivalent to agency theory which says that self-satisfaction drives managers to do opportunistic earnings management.

Management engages in real earnings management so that sales will increase in the future and this is the company's response to poor performance. However, the increase in sales are not followed by an increase in normal cash inflows. For example, the increase in sales due to the provision of large discounts as part of real earnings management practices. In addition, managers cut discretionary costs such as advertising costs, as well as research and development costs in order to achieve profit targets. However, cutting these costs can reduce the company's competitiveness. For example, cutting research and development costs can result in decreased company innovation.

Opportunistic earnings management tends to be carried out by managers only for good earnings reporting by ignoring its future impact. Management in Indonesia is more likely to manage earnings for self-interest than for the benefit of the company and stakeholders, so earnings management in Indonesia is opportunistic.

There are three control variables in this study, namely: firm size (FSIZE), audit quality (BIG4), and firm growth (GROWTH). According to the results of the study, firm size (FSIZE) has a positive effect on the future performance of the company. This means that the larger the size of the company, the better the company's ability to

generate profits will be. In accordance with the research of Tabassum et al. (2015) which shows that large companies have large company resources and good market share, so the company's performance is good. Research also proves that BIG4 has a positive effect on the company's future performance. Indonesia's accountancy companies that affiliated with Big 4 companies tend to provide quality audit services. A quality audit means that the auditor is able to find and disclose violations related to his client's accounting system. A quality BIG4 will enable companies to generate higher quality earnings because they are able to limit the opportunist behavior of managers. Meanwhile, the company's growth (GROWTH) has no effect on the company's future performance. This shows that the company's growth is not able to provide a good signal of performance. This is because opportunistic earnings management results in misleading reporting of business performance projections so that the company's growth and profits cannot be a good signal of the company's performance.

The coefficient of determination test or R^2 tests how much influence the independent variables have on the dependent variable. The coefficient of determination test uses the adjusted R^2 value because the regression model used is multiple linear regression. The value of adjusted R Square is 0.147 or 14.7%. These results indicate that the variables REM, FSIZE, BIG4, and GROWTH affect the company's future performance by 14.7%.

5. CONCLUSION

Based on the results of the data analysis, it can be concluded that earnings management practices in Indonesia affect the future performance of companies. In addition, this research also provides empirical evidence showing that earnings management practices in Indonesia are opportunistic. This study only uses a sample of manufacturing companies so its findings cannot be generalized for companies in other industries. Further studies could conduct research in other industries by modifying the real earnings management proxies.

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