CHAPTER 2

THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

2.1 Literature Review

2.1.1 Earnings Management

Schipper (1989) defined earnings management as: “ A purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process).”

Kothari et al. (2005) argued that companies with extreme high performance are more likely engaged in earnings management compared to company that has poor performance. It is proven that the practice of earnings management often provide inaccurate and misleading financial reports because the financial information stated there are not the truth amount which generated from the real business operation (Healy and Wahlen, 1999).

In its development, the role of accrual accounting is believed to have caused some forms of earnings management and it is difficult to distinguish between the manipulated accruals item from the appropriate accrual accounting choice (Dechow and Skinner, 2000). There are some technique used to manage earnings by the management, those are: big bath, cooking jar reserve, income maximization and income minimization.

Manager as the person who run the company in daily basis, sometimes, tend to get involved in earnings management practices in order to hide unlawful transactions and thus, face high litigation risk. In another purpose, management intentionally tries to maintain the reputation of the company by showing that their companies are performing well in the market. Obviously, that's because manager will get better compensation such as bonus, job security, job security, stock awards, pension contributions and future promotion. The study also found if managers tend to use accounting accruals to boost upward the earnings and the company will be able to get positive earnings pattern and influence the market perception.

2.1.2 Earnings Management Technique

Earnings Management can be classified into two categories, which are accrual earnings management and real activity based earnings management. Accrual earnings management is a manipulation of accruals with no direct cashflow consequences (Roychowdury, 2006) that involves within GAAP accounting choices that try to "obscure" true economic performance. The examples such as under-provisioning for bad debt expenses and delaying assets write-offs. In the other hand, real earnings manipulation can affect both cash flows and accruals (Roychowdury, 2006). Real earnings manipulation may occurs when managers decide to change the timing or structuring of an operation, investment, and/or financing transaction in an effort to influence the output of the accounting system (Gunny, 2010). Real earnings manipulation that has been done by the manager may signaling impressive short term performance of the company, however it is potentially will reduce company's value.

When firms change the timing or structuring of real business transaction in intention of doing manipulation to boost earnings, they actually depart from normal operational practices which may deviate from the optimal plan of actions and impose a real cost to the firm (Xue et al., 2007). Accrual earnings management is not accomplished by changing the underlying operating activities of the firm, but through the choice of accounting methods used to represent those activities. In contrast, Real earnings management involves changing the firm's underlying operations in an effort to boost current period earnings. Both type of earnings management attempt to increase or decrease earnings, however, one type affects operations and the other has no effect on operating activities. (Gunny, 2010).

2.1.3 Real Earnings Management

On the basis of documented literature, mainly there are six types of real activities manipulation overall, those are:

1) Manipulation in Research and Development (R&D) expense
2) Manipulation of Sales, General and Administrative (SG&A) expense
3) Manipulation in Advertising expense
4) Overproduction, or increasing production to report lower cost of goods sold
5) Timing the sale of long lived assets and long lived investment to report gain
6) Sales manipulation, which is, boost up the sales through increased price discounts or offering lenient credit terms.

Real earnings management potentially imposes greater long-term costs on shareholders than accrual earnings management because it has negative consequences on future cash flows and might hurt firm value in the long run (Roychowdhury 2006; Cohen et al. 2008; Cohen and Zarowin 2010). Such long-term costs are driven by temporary price discounts or more lenient credit terms that lower margins on future sales, reductions in valuable investments in research and development and SG&A activities, and/or increasing investments in unneeded inventories via inventory over-production (Roychowdhury, 2006).

Managing real activities is less costly to managers because it is less likely to draw auditor or regulatory scrutiny (Cohen et al. 2008). Real earnings management, as long as it is properly disclosed in the financial statements, cannot influence auditors' opinions or regulators'actions (Kim et al. 2010). Hence, managers could prefer real earnings management to accrual earnings management (Roychowdhury 2006). There are three main focus of the real earnings manipulation in this research, those are: sales manipulation, overproduction, and reducing discretionary expense.

Sales Manipulation

Managers will try to increase or accelerate future sales in the current period in order to reach the targeted earnings by offering interesting and attractive limited time price discount and more lenient credit terms (Roychowdhury, 2006). If the targeted earnings was reached, this short term performance will seems stupendous and managers will get the bonus. The impact of this additional discounts will reduce the cash inflow per sale as the margin of sales also decline. When managers accelerating the future sales in the current fiscal year, there also will be a potential decline in cash inflow in the next period. In general, sales management activities potentially lead to lower current period CFO and higher production cost than on its normal sales level.

Overproduction

Managers can manage the earnings by doing the high production scale to reach the expected demand. With a big amount of production, the level of fixed overhead also will be divided into huge number of units produced. Hence, the fixed overhead per unit will be lower and so does the total cost per unit. This will make the reported COGS lower and better earnings margin. But producing more goods means if firm incurs production and holding cost on the over produced items that are not recovered in the same period through sales. Therefore, it will give negative impact for the future CFO.

Reduction of Discretionary Expenses

There are several studies proving that managers cut discretionary expenses to meet earnings target. Discretionary expenditures such as Research and Development (R&D) and Sales, General and Administrative (SG&A) are generally expensed in the same period as they incurred. Therefore, managers can decrease reported expense and increase earnings by cutting discretionary expenses. Some example of SG&A expenditures are employee training expenses, repair expense, maintenance expense, quality control, travel expense, research and development expense. If outlays of those kind discretionary expenditures mostly conducted in cash, then, reducing those expenditures will lower cash outflow and has positive effect on abnormal CFO in the current period (Roychowdhury, 2006). However, a reduction in discretionary cost mean if the company deviate its normal operating business and will affect future operating cashflow. For example if management decide to reduce repair and maintenance expense, then it will lower cash outflow in the current period. But those kind of expenses are required in every period of business. In the end the company has to expense more repair and maintenance expenses in the future in order to cover from the previous period. Then, it will lower the operating cashflow in the future.

2.1.4 Cash Flows

Financial statements is a useful tool for all of the company's stakeholders to get information, especially for the financial conditions recently in a period of time. Financial statements consist of several reports such as the statement of financial position, statement of comprehensive income, statement of changes in owner's equity and statement of cash flows. Cashflow information is useful as a basis for the companies to asses the ability of generating cash and cash equivalent and asses the company's need to use cash.

According to PSAK 2 (revision 2009), statement of cash flow has to report cash flows for a certain period of time and classified into three activities, those are: Activity from operation, activity from investment and activity from financing. Activity from operation decide if company's activity would be able to generate enough cash to settle debts, maintain operational ability of the company, pay dividend and provide new investment without relying on outside resources. Activity from investment reflects the expensed cash used for purposed resources in generating income and future cashflow. Activity from financing is an activity which affect changes in amount and composition of company's capital and loan.

Cashflow information gives benefits for the stakeholder to make decisions, for example:

- For Managers: Information from cashflow can help the financial manager in preparing budget for the next annual period and timing to decide whether to expand their business.
- For investors: From cashflow information Investor will be able to understand how a company running their operations, where its money coming from and how the money are spent, that will be related to investment decision.
- For Creditors: It also help the creditor in assessing a company's financial ability for payback the loan. This will lead to the willingness of the creditor in lending the money to the company related with its financial strength.

2.1.5 Cash Flows from operation

The amount of cash flows from operating activities is a key indicator of the extent to which the operating activity of the company have generated sufficient cash flows to organize the operating capability of the company, pay dividends, repay loans and make new investment without external financial sources.

Cash flows from operating activities are primarily generated from the principal revenue-producing activities of the company. Therefore, they generally result from the daily transaction and other events which can be determined to net profit or loss. Examples of cash flows from operating activities are:

1) Cash receipts from the sale of goods and the rendering of services

2) Cash receipts from fee, commission and other revenue
3) Cash payment to suppliers for goods and services
4) Cash payments to and on behalf of employees

There are two method that can be used to report cash flows from operating activities. The company can use either direct method or indirect method. When using the direct method, major classes of gross cash receipts and gross cash payments are disclosed. In contrast, the indirect method provide the adjusted net profit or loss for the effect of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The direct method provides information which useful in estimating future cash flows and which is not available under the indirect method. Therefore, the direct method is considered more preferable then the indirect method for providing information of cash flows from operation.

2.2 Previous Research

Dey and Lys (2008) find that a greater regulatory focus on accruals management is associated with an increased managerial propensity to engage in real activities manipulation. They conclude that the more stringent regulatory environment after the passage of the Sarbanes Oxley Act in 2002 lowered accruals management, but increased real activities management.

The use of RM by managers is supported by Graham et al.(2005), who surveyed 401 financial executives about key factors that drive decisions about reported earnings and voluntary disclosure. They report that 78% of the executives interviewed indicated a willingness to sacrifice economic value to manage financial reporting perceptions.

Several studies provide evidence that managers cut discretionary spending to achieve earnings targets. Roychowdhury (2006) investigates some real earnings management; reduction of research and development expenditures, advertising expenditures, and cost of sales. He also develops empirical measures to proxy for RM of discretionary expense, and reports that managers avoid reporting losses by undertaking RM.

Real activities manipulation can assume many forms, including decreased investment in research and development (R&D), advertising, and employee training, all for the purpose of meeting short-term goals (Graham, Harvey and Rajgopal, 2005; Roychowdhury, 2006)

Real activities manipulation is potentially costlier for firms in the long run than accruals management (Cohen and Zarowin, 2010). Because, when manager decided to use real activity manipulation, actually, they bring the company into abnormal operating activity that it should be. Research from Gunny (2005) and Xu (2007) also suggest that abnormal operating activity for the purpose of misrepresentation will have a negative impact on subsequent operating performance. Cohen and Zarowin (2009) also find evidence that firms engaging in real earnings management over-invest, which could adversely affect firms' long-term prospects.

In Indonesia, there are some research about real earnings management that have been done . According to Oktorina and Megawati (2008) companies which did earnings management through real activity manipulation will give impact to the lower availability of abnormal cashflow from operation. Another research from Hariyani (2011) found that companies who did real earnings management will have lower profitability compared to companies who didn't engage in real earnings management.

2.3 Hypothesis Development

There is some indication if real earnings manipulations will have negative impact on future operating cash flows. Even though REM benefits in the current time or short term, but it will impose greater long term cost for the company. In detecting the real activities manipulation, like in the previous research from Roychowdhury (2006), Leggett.et al. (2010), and Tabassum (2013) this research also investigate patterns in CFO that represent cashflow from operations as reported in cashflow statement and relate them with the firm's discretionary expenses and production cost.

The frist method of REM is through sales manipulation. Sales manipulation here means if the company offering interesting and attractive limited time price discount and more lenient credit terms. Roychowdhury (2006) explain if the manager decide to use REM in sales manipulation with giving high discount to increase sales volume and meet short term earnings target, therefore, it can lead customers to expect such discount in future period as well. Company who engaging in REM is usually has lower performance compared with the other company who didn't engage in REM. Therefore, there is no guarantee if company would be able to give such high price discount in the future period compared in the period when they committing in REM. They may suffer loss or decreased income if they keep cutting the profit margin of their product by giving such high price discount in the next period. So, if the company cannot provide same discount in the future period in order to fulfill customer's expectation, then there will be a risk that company's sales will decrease. Their customer will change to company's competitors who have better performance and able to provide lower price or higher amount of discount. Then, it concludes that sales manipulation will give effect in reducing the margins on future sales that also will give negative impact for cash inflow from operation in the future.

The second method of REM is overproduction. If manager decide to use REM in overproduction to decrease the cost of goods sold valuation, thus, it will decrease the future cashflow from operation. In the normal operation usually company has their own budget and capacity of production. But when company attempt earnings management, it means that company shifted from their normal business operating activity, for this example overproduction. When company did overproduction, they obviously produce their product beyond their capacity and also they need more massive amounts of materials compared with their normal business activity. Therefore, company who attempt overproduction may surpass their budget capacity in providing materials needed to be produced. This second method is actually related with the first method of REM which is sales manipulation by giving more lenient credit terms. Giving more lenient credit terms, means if the company may have cash shortage due to the delayed payment from the customer. In the other hand, company who attempt REM through overproduction need more cash to buy materials needed from suppliers. If the amount of cash is not sufficient enough to cover the payment to supplier, the only way to buy materials is using debt to supplier. Hence, in the future period company have to pay bigger amount of debt than usual and, thus, lower the cashflow from operation in the future period.

The third method of REM is reducing discretionary expense in the current period. Discretionary expenses in here are like research and development expenses (R&D) and selling, general and administrative expenses (SG&A). Expenses such as: salary expense, depreciation, and taxation also will be excluded from discretionary expense in this research. Even though the company will get higher earnings in the current period for reducing such expenses, but actually it will give lower operating cashflow in the future. For example, if manager decide to reduce discretionary expense such as advertising expense, the company will lack of sales and potentially decrease their market share. In manufacturing industry, it is important to have a good advertisement in order to attract customers and boost their sales. If a company reduce their advertising expense, then, they cannot compete with their competitors in terms of selling their product. Therefore, company engaging in REM by reducing their discretionary expense will have effect on lower future operating cashflow.

Research from Graham et al.(2005) document if CFOs (Chief Financial Officer) admitting willingness to engage in real manipulation as long as the real sacrifies are not to large and still within GAAP. This survey indicating if managers are opportunistically use real earnings manipulation to enhance the firm’s financial performance. But, another research from Gunny (2010) present that using real earnings manipulation to influence output of the accounting system is not opportunistic but consistent with managers attaining benefits that allow better future performance or signaling.

The extant literature gives little evidence on the magnitude of real manipulation earnings that derived from real business strategies on future performance (Xu et.al. 2007). Intuitively, manipulation of earnings operation such as from R&D, capital investment, and production causes deviation to firm normal operational decision and practices that potentially can lead to descent firm's subsequent performance (Roychowdhury, 2004). Gunny (2010) investigates that using real activities manipulation to just meeting earnings benchmark is positively associated with future performance compared to firms that do not engage real manipulation and miss the earnings benchmark.

Research from Leggett, et.al.(2010) found that firms that using REAM to avoid loss have significantly lower one-year-ahead earnings and operating cash flows than firms reporting a loss. They also found that firms that using REM to meet or barely beat earnings forecast have significantly lower one-year-ahead ROA and operating cash flows than non-REM firms meeting or barely beating earnings forecast. This research examines whether there is an affect of real earnings manipulation toward firm's future performance which indicated by future operating cash flows. Then, the hypotheses would be:

H1: Real earnings management has negative impact on firm's future operating cash flows