

CHAPTER II

THEORETICAL BACKGROUND AND PREVIOUS RESEARCHES

2.1. Global Financial Crisis

2.1.1 The Origin of Global Financial Crisis 2008-2009

The fall in house prices led to a fall in the prices of securitized subprime mortgages, affecting financial markets worldwide. In March of 2008 the Federal Reserve bailed out Bear Stern through an arranged merger with J. P. Morgan. Public funds and guarantees were required to induce J. P. Morgan to engage in the transaction.

Although the financial system and in particular banks came under tremendous pressure during this time, the real economy was not much affected. All that changed in September 2008 when Lehman's demise forced markets to re-assess risk. While Lehman's bankruptcy induced substantial losses to several counterparties, its more disruptive consequence was the signal it sent to the international markets. Re-assessing risks previously overlooked, investors withdrew from the markets and liquidity dried up. In the months that followed and the first quarter of 2009 economic activity in the U.S. and many other countries declined significantly. Unemployment rose dramatically as a result (Allen, Babus, and Carletti; 2009).

2.1.2 The Impact of Global Financial Crisis to the World

Kuncoro (2009) said report of world economic outlook which has been released by the IMF predicts a grim picture of the global economy in 2009. In 2009, world economic growth has been predicted to an extremely small number, only 0.5%. This world economy chaos occurs as a result of globalization of financial crisis that has rocked the U.S. financial market which is then being transmitted to the financial economy markets of other developed countries in Europe, Japan, and eventually to the whole world. Trade volume growth fell to 2.8% as a result of declining demand for goods and services in developed countries which are experiencing a recession due to global financial crisis. The falling of demand for goods in developed countries is what causes the growth of developing country's exports fall, which also gives results to the falling of economic growth in developing countries.

Based on the IMF report, the economy of developing countries will grow by 3.3% in 2009, while the economies of developed countries like USA, European countries, and Japan will experience negative growth with average growth of -2% in 2009. The U.S., Europe, and Japan economy's output experienced a contraction, amounting to -1.6%, 2%, and -2.6%.

According to IMF forecasts, economic growth in China, India, and ASEAN-5 will still in a high level, namely at 6.7%, 5.1%, and 2.7% for each country in 2009. Nevertheless the economic growth of China and India are

also dropped dramatically from 2008. In 2008, China grew by 9%, India 7.3%, and the countries of ASEAN-5 at 5.4%. Decline in economic growth in China and India can not also be separated from the impact of the financial crisis in the U.S. and Europe which brings their economies into recession. Exports of goods from China and India are largely destined for developed countries like the U.S., Europe, and Japan decrease dramatically. As a result, economic growth in China, India, and ASEAN-5 have also been decreased.

2.1.3 The Impact of Global Financial Crisis to Indonesia

Indonesia as a developing country in Asia was not immune from the global crisis. In the year 2008, Indonesia's economic growth still increased 6.2%, which means lower than government's target 6.5%. In 2009, Indonesia's economic growth is expected to fall drastically in the range of 4.5 to 5.5%. Indonesia hit by the recession that occurred in the U.S. and developed countries because these countries are the main export destination of Indonesian commodity products. By the declining demand for Indonesian products in developed countries, the export value of Indonesia experienced a significant declining. This is reflected in the declining of growth in export value of Indonesia. According to SMERU Research Institutional (2009), the industries most frequently reported as having been affected by the 2008/09 global financial crisis are the textiles and textile products groups (including

garments), handicrafts, wood and wooden products (including furniture and rattan), paper, and electronics. News about the effect on the food and beverage industry and the fishing industry is more limited. The measures adopted by the various industries in attempting to overcome the downturn include the dismissal of contract, daily, and even permanent workers.

2.2 Earnings Management

2.2.1 Earnings Management Definition

Earnings management is the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective (Scott, 2011). In order for financial reports to convey more useful and valuable information to users, managers must be permitted some degree of judgment in selecting reporting methods, estimates and disclosures appropriate to the underlying business economics of the firm. (Fong, 2006 as cited in Healy and Wahlen, 1999). However, neither accounting nor auditing is an exact science. As it is the firm's management which decides how information contained in financial reports is to be presented, there is a risk of earnings management, whereby managers select estimates and reporting methods which do not accurately reflect the firm's underlying economics (DeAngelo, 1986 as cited in Fong, 2006). Moreover, Gumanti (2000) said that earnings management performed by manager because they expect benefit

from actions taken. Earnings management could give description about manager's behavior in order to report their business activities in certain period of time, which there is possibility of particular motivation which push managers to manage or set financial data reported. While according to Setiawati and Na'im (2000), earnings management arise as a result of the use of accounting as an information and communication tool between company's internal and external corporate parties, so that it give rise to management to make policy.

2.2.2 Motivations of Earnings Management

According Scott (2003), motivations for earnings management is explained as follows:

1. Bonus plan purposes

Profit is often used by company to measure management performance. Commonly, companies set the targeted profit to be achieved in the certain period, so managers are pushed to achieve the target. All other things being equal, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to current period. Firm managers, like everyone else, would like high remuneration. If their remuneration depends, at least in part, on a bonus related to reported

net income, then they may be able to increase their current bonus by reporting as high a net income as possible. One way to do this is to choose accounting policies that increase current reported earnings. Of course, because of the nature of the accrual process, this will tend to lower future reported earnings and bonuses, other things equal. However, the present value of the manager's utility from his or her future onus stream will be increased by shifting it towards the present.

2. Contractual motivations

Debt contracts typically depend on accounting variables, arising from the moral hazard problem between manager and lender. To control this problem, long-term lending contracts typically contain covenants to protect against actions by managers that are against the lenders' best interests, such as excessive dividends, additional borrowing, or letting working capital or shareholders' equity fall below specified levels, all of which dilute the security of existing lenders. All other things being equal, the closer a firm is to violation of accounting-based debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the current period. The reasoning is that increasing reported net income will reduce the probability of technical default. Most debt agreements contain covenants that the borrower must meet during the

term of the agreement. For example, a borrowing firm may covenant to maintain specified levels of debt-to-equity, interest coverage, working capital, and/or shareholders' equity. If such covenants are violated, the debt agreement may impose penalties, such as constraints on dividends or additional borrowing.

3. Political motivations

Earnings management is conducted by managers in order to reduce political costs and government supervision. Those companies that perform earnings management with this motive tend to accounting method that will reduce their profit. Companies deal with it because they want to reduce public visibility in order to avoid highlighted by the public. All other things being equal, the greater the political costs faced by a firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods. The political cost introduces a political dimension into accounting policy choice. For example, political costs can be imposed by high profitability, which may attract media and consumer attention. Such attention can quickly translate into political heat on the firm and politicians may respond with new taxes or other regulations. Often, sheer size can lead to political costs. Very large firms may be held to higher performance standards, for example with respect to

environmental responsibility, simply because they are felt to be large and powerful. If the large firms are also highly profitable, such political costs will be magnified. Also, firms may face political costs at particular points in time. Foreign competition may lead to reduced profitability unless affected firms can influence the political process to grant import protection. One way to do this would be to adopt income-decreasing accounting policies in an attempt to convince the government that profits are suffering.

4. Taxation motivations

It is obvious if the higher profit gained by company, the higher tax will company paid to government. Setiadi (2009) stated that manufacturing company conduct income decreasing earnings management through discretionary accruals as response to the change of income tax law in 2008. Managers try to minimize the profit in order to avoid high tax expense.

There are various ways could be done by managers to manage company' profit in order to minimize corporate tax. For example, company increases their percentage of bad debt expense in order to increase bad debt expense. If bad debt expense increase, it will reduce company' profit, this will make tax that must be paid to government will get smaller.

5. Changes of CEO

Earnings management is done at the change of CEO. The old CEO will report a high rate of profit after in the prior period; they decrease company's profit, so the new CEO will face the difficulties in order to achieve the high rate of profit. The old CEO performs earnings management with the aim, in the next period they can be re-elected by the Board of Director.

6. Initial public offerings

When company decides to go public, managers deal with earnings management in order to influence investor's decisions. The use of accounting information and financial analysis to value the stock price could create incentive for managers to manage company earnings in order to influence stock price. When at IPO, prospectus is the only one source because besides prospectus, almost no other information available for investors. So, investors tend to rely on prospectus in order to get information and assess company that will do IPO.

7. Stock price effect

Managers conduct earnings management in order to affect the stock price traded on stock market. For example: managers provide a good and healthy financial statement, they provide a high profit with

the aim to receive positive response from the market and expect company stock price will increase.

2.2.3 The Patterns of Earnings Management

According to Scoot (2009), pattern of earnings management that conducted by managers are as follows:

a. Taking a Bath

Taking a bath is conducted by manager if company suffers a bad economic condition, and could not be avoided, recognized future expenses and total loss in the current period.

b. Income Minimization

This earnings management pattern is conducted if company has a high profit. In bonus plan case, managers that realize current profit approaching the 'cap' will conduct income minimization in order to maintain their bonus. Company that has high profit but does not want public or political attention could be conducted this pattern.

c. Income Maximization

This earnings management pattern is conducted if company has a low profit. In bonus plan case, managers that realize current profit approaching the 'bogey' will conduct income maximization in order to keep their bonus. In IPO case, managers could also conduct income

maximization in company prospectus in order to increase company profit with the aim to give good impression to potential investors.

d. Income Smoothing

Income smoothing is conducted by managers in order to make company performance looks stable overtime. It could give good signal to investor that will consider the company has good performance. Managers also could do income smoothing in order to keep company profit between bogey and cap with the aim to maintain their bonus.

2.2.4 The Methods of Earnings Management

According to Lilis and Ainun (2000), the methods to conduct earnings management can be classified into three groups, those are:

1. Organizing the Periods of Cost or Revenue

Standar Akuntansi Keuangan (SAK) obligates corporation for using accrual basis in recording of financial statement (except for cash flow statement). As a result, management has opportunities to manipulate financial statement. For instance:

- Accelerate / postpone the sending of the goods to the customers.
- Organize the selling of unusable fixed assets.

- Accelerate / postpone the spending for research and development expenses and also promotion expense to the next period.

2. Implementing of Standard Accounting Policy

In terms of the implementation of new accounting policy, manager has tendency to implement it earlier or postpone it until the effective date. If by applying the new accounting policy earnings will be increased and high earnings rate is also expected by the company, then company will implement the new accounting policy earlier and vice versa. For example, the implementation of *Pernyataan Standar Akuntansi Keuangan* (PSAK) No. 16 Years 2007 as the revision of PSAK No. 16 Years 1994 about fixed asset. By implementing the new accounting policy (using asset revaluation instead of cost method for fixed asset), surplus from differences in changing of depreciation method of fixed asset will be recognized as deficit and vice versa.

3. Changing of Accounting Method and Estimation

In the recording of financial statements, companies have the freedom to choose the accounting method correspond primarily to the methods permitted by applicable accounting standards. This will provide an opportunity for management to choose and change the company's accounting methods. The management will try to change

and choose the method of accounting in accordance with the conditions of the company during the period. But the company is not free as it is to change its accounting methods, because of changes in accounting methods and its reasons must be disclosed in the notes of financial statements. That change must also be based on rational grounds and can be received by the applicable accounting standards. For example, company changed depreciation method from straight line into declining balance. Next, accounting methods provide flexibility for management in recording a certain fact involved by subjectivity in making an accounting estimation. The example of it is in estimating the period of fixed assets- and intangible assets depreciation and also for bad debt estimation.

2.3 Positive Accounting Theory

Scott (2003) stated that positive accounting theory (PAT) is concerned with predicting such actions as the choices of accounting policies by firm managers and how managers will respond to proposed new accounting standards. Positive Accounting Theory, as developed by Watts and Zimmerman (1986), is based on the central economics-based assumption that all individuals' action is driven by self-interest and that individuals will always act in an opportunistic manner to the extent that the actions will increase their wealth. Notions of loyalty, morality and the like are

not incorporated in the theory (as they typically are not incorporated in other accounting or economic theories). Given an assumption that self-interest drives all individual actions, Positive Accounting Theory predicts that organizations will seek to put in place mechanisms that align the interests of the managers of the firm (the agents) with the interests of the owners of the firm (the principals).

According to Scott (2003), the predictions made by PAT are largely organized around three hypotheses, formulated by Watts and Zimmerman (1986). These hypotheses will be given in their opportunistic form, since according to Watts and Zimmerman (1986), this is how they have most frequently been interpreted. By opportunistic form, it can be said that managers choose accounting policies in their own best interests, which may not necessarily also be in the firm's best interests.

The hypotheses are the bonus plan hypothesis (all other things being equal, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to current period), the debt covenant hypothesis (all other things being equal, the closer a firm is to violation of accounting-based debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the current period), the political cost hypothesis (all other things being equal, the greater the political costs faced by a firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods).

2.4 The Impact of Global Financial Crisis to Earnings Management

The financial crisis quickly spread throughout the U.S. economy and the rest of the world and by the second half of 2008 resulted in recessions in numerous countries (Shane, Mathew et al. 2009).

Acute liquidity crisis in the global financial market has caused a slow-down of economic progress in many major economies especially in the US and Europe. This is clearly illustrated by the fact that in 2009, a number of economies such as Japan, America, and some of European countries still have a negative economic growth (www.depkeu.go.id/ind/Data/Artikel/art_101110_1.pdf).

Kuncoro (2009) said report of world economic outlook which has been released by the IMF predicts a grim picture of the global economy in 2009. Based on the IMF report in 2009, the economy of developing countries will grow by 3.3% in 2009, while the economies of developed countries like USA, European countries, and Japan will experience negative growth with average growth of -2% in 2009. The U.S., Europe, and Japan economy's output experienced a contraction, amounting to -1.6%, 2%, and -2.6%.

During global financial crisis, manufacturing industry experienced slow growth due to re-arrangement of foreign investors' capital and decreasing in exports level. In the period of end-2008 till end-2009, there was a slope of the export level of manufacturing industry. Even in the early of 2009, the export level declined to \$7 billion US Dollar. By the declining of export level and price increasing of raw

imported materials, operating activities of manufacturing companies will be affected in case of stock accumulation and increasing in production costs. Next, it will bring further impact to decreasing in company's earnings.

During financial crisis whereas company's earnings decreased, managers tend to do income decreasing earnings management. Earnings management performed by manager because they expect benefit from actions taken. Earnings management could give description about manager's behavior in order to report their business activities in certain period of time, which there is possibility of particular motivation which push managers to manage or set financial data reported (Gumanti, 2000). According to Scott (2011) earnings management is the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective. Earnings management namely can include both accounting policy choice and real actions. Some of the examples of earnings management are the choice of accounting policies per se, such as straight-line versus declining-balance amortization or policies for revenue recognition and also provisions for credit losses, warranty costs, inventory values, and timing and amounts of non-recurring and extraordinary items such as write-offs and provisions for reorganization (Scott, 2003).

The reason behind this action (decrease company's earnings) is namely known as political costs or motivations. Political costs include all expected costs (wealth transfers) imposed on a firm from potential adverse political actions involving antitrust, regulation, government subsidies, taxes, tariffs, etc (Watts and

Zimmerman, 1978 as cited in Han and Wang, 1995). Here, taxes motivations seem to be more relevant with earnings management's case in Indonesia because many taxation rules exist and regulate companies. In a profit condition, company in Indonesia usually has to pay tax. The amount of the tax also depends on the amount of profit, the greater the profit the bigger the tax. But during loss condition company will get different treatment. According to Income Taxation No. 36 Year 2008, "If the gross profit after deductions provided in paragraph (1) result in a loss, the loss is compensated by the gross profit starting next year in a row up to 5 years". So, in a loss condition, company is not eligible to pay tax. Then, in the next following year, if company earns some profits then it does not have to pay tax due to the compensation of last year's loss. By decreased earnings during global financial crisis, companies expect that it will help them to quickly recover from this condition. Earnings management could be measured by using discretionary accrual proxy. The definition of discretionary accrual is accrual item in financial statement that could be controlled by managers, which mean managers can make intervention in those items.

Based on political costs as explained above; managers tend to engage in income decreasing earnings management during crisis period and also firms engaged in more income decreasing earnings management than in the preceding comparative period during global financial crisis 2008-2009.

2.5 Previous Researches

The research of Han and Wang (1995) shows that oil firms that expected to profit from the crisis used accruals to reduce their reported quarterly earnings during the Persian Gulf crisis. This finding suggests that the benefit of disclosing “good news” (i.e., earning increases) early may have been out-weighed by the political costs associated with timely releases of the information.

Sanjaya and Raharjo (2006) stated that if a firm must report a loss, management may feel compelled to report a large one. Consequently, it will write off assets, provide for expected future costs, and generally clear of decks. This will enhance the probability of future reported profits. Income minimization is similar to taking a bath, but fewer extremes. A politically visible firm may choose patterns during periods of high profitability. Policies that suggest income minimization include rapid write-offs of capital assets and intangibles, expensing of advertising and R&D expenditures. This research shows that during crisis, managers have tendencies to decrease earnings.

The Asian financial crisis has a negative effect on the performances of companies and provides the incentives for managers to engage in earnings management. Healy and Wahlen (1999, p. 368) suggest that earnings management happens when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholder about the underlying economic performance of the company, or to influence contractual

outcomes that depend on reported accounting numbers. This definition implies that managers have incentives to manage earnings around the specific, predictable events of the reporting of the periodic earnings. This paper investigates and documents the presence of negative earnings management activities in service-oriented public-listed companies in Singapore during the Asian financial crisis. (Chia, Lapsley, and Lee, 2007).

Moreover, Spring (2011) said that in the years of the crisis, the smoothing proxy was significantly lower, indicating that income smoothing was less pronounced during this time. On the other hand, the research finds a significant positive relation between the years of crisis and the big bath proxy. They provide analytical evidence that firms move from an income smoothing equilibrium to a 'big bath' equilibrium once their cash flows become sufficiently low. They argue that with larger earnings surprises (i.e. extreme results on either end of the range) the inferred precision of reported earnings is reduced. Hence, a greater negative earnings surprise only under proportionally affects the value of the firm, as shareholders attribute a lower inferred precision to the reported result, thus providing incentives to take a big bath if the initial result is sufficiently low. The recent crisis provides a suitable setting to empirically test these predictions, as a considerable number of firms suffered significant negative shocks.

Then, Bachtiar, Shauki, and Harahap (2011) found that firms that are expected to have lower profit due to crisis used accruals to increase their reported earnings

during the global financial crisis did not engage in income increasing earnings management (evidence from the Australian listed manufacturing companies between 2005 and 2009).

Table 2.1
Summary of Previous Researches

Research's Title	Research's Result
Political Costs Earnings Management of Oil Companies during the 1990 Persian Gulf Crisis	Oil firms that expected to profit from the crisis use accruals to reduce their reported quarterly earnings during the Persian Gulf crisis.
<i>Uji Beda Manajemen Laba Sebelum dan Selama Krisis di Indonesia</i>	Managers have tendencies to decrease earnings during crisis.
Choices of Auditors and Earnings Management during the Asian Financial Crisis	This paper investigates and documents the presence of negative earnings management activities in service-oriented public-listed companies in Singapore during the Asian financial crisis.
Earnings Management in the Financial Crisis	The result shows that in the years of the crisis, the smoothing proxy was significantly lower, indicating that income smoothing was less pronounced during this time. On the other hand, the research finds a significant positive relation between the years of crisis and the big bath proxy.
Earnings Management during Global Financial Crisis: Evidence from the Australian Listed Manufacturing Companies between 2005 and 2009	This research found that firms that are expected to have lower profit due to crisis used accruals to increase their reported earnings during the global financial crisis did not engage in income increasing earnings management (evidence from the Australian listed manufacturing companies between 2005 and 2009)

2.6 Hypothesis Development

The effect of global financial crisis transmitted to the Indonesia economy initially in mid-September 2008. The most visible can be seen in manufacturing industry that experienced slow growth during the crisis due to rearrange of foreign investors' capital and decreasing in exports level. According to SMERU Research Institute (2009), the industries most frequently reported as having been affected by the 2008/09 global financial crisis are the textiles and textile products, including garments group, handicrafts, wood and wooden products (including furniture and rattan), paper, and electronics.

During global financial crisis 2008-2009 whereas company's earnings decreased, managers have tendency to decrease earnings. Managers actually have their own reason in doing income decreasing earnings management. This action seems to have correlation with political motivation (especially for taxation motivation). Political costs include all expected costs (wealth transfers) imposed on a firm from potential adverse political actions involving antitrust, regulation, government subsidies, taxes, tariffs, etc (Watts and Zimmerman, 1978 as cited in Han and Wang, 1995). By decreasing earnings, company expects to have reduction in tax payments. Firms expect to decrease company's earnings during financial crisis due to this taxation motivation. According to Government Act No. 17 Year 2000 chapter 17 about Income Tax and the revision version of it, Government Act No. 36 Year 2008 chapter 17 about Income Tax, "If the gross profit after deductions provided in

paragraph (1) result in a loss, the loss is compensated by the gross profit starting next year in a row up to 5 years". So, in a loss condition, company does not have to pay tax. Then, in the next following year, if company earns some profits then it does not have to pay tax due to the compensation of last year's loss. By decreased earnings during global financial crisis, companies expect that it will help them to quickly recover from this condition because of fewer amounts of taxes that should be paid to government.

Furthermore, some researches about financial crisis and earnings management had been conducted before. Most of those researches found that managers tend to do income decreasing during crisis period. Han and Wang (1995) shows that oil firms reduce their reported quarterly earnings during the Persian Gulf crisis. Raharjo and Sanjaya (2006) find that there managers tend to decrease earnings during financial crisis in 1997. Chia, Lapsley, and Lee (2007) say about the presence of negative earnings management activities in service-oriented public-listed companies in Singapore during the Asian financial crisis. Spring (2011) finds a significant positive relation between crisis and big bath proxy. Bachtiar, Shauki, and Harahap (2011) detect that during the global financial crisis firms did not engage in income increasing earnings management.

This research will use journals from Sanjaya and Raharjo (2006) and also Bachtiar, Shauki, and Harahap (2011) as references. The research from Raharjo and Sanjaya used listed manufacturing companies in Indonesia during Asian financial

crisis as sample and the research from Bachtiar, Shauki, and Harahap used Australian listed manufacturing companies during global financial crisis as sample; while this research will use listed manufacturing companies in Indonesia during global financial crisis 2008 as sample. This research uses two years observation period during financial crisis, with the objective whether during financial crisis, firms expect to engage in income decreasing earnings management. This research only uses modified Jones model developed by Dechow (1995) to calculate discretionary accruals as a proxy for earnings management. Based on the explanation above, formulation of hypotheses proposed for this research is:

H₁: Listed manufacturing companies in Indonesia engage in income decreasing earnings management during global financial crisis.