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ARE MANAGER POLICIES ASSOCIATED WITH EARNINGS MANAGEMENT ACTIVITY?

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Abstract

The effect of derivative ownership, leverage, and tax avoidance on earnings management is investigated in this study. From 2018 to 2021, samples were drawn from manufacturing sector companies listed on the Indonesia Stock Exchange. Based on the purposive sampling technique, this research sample included 72 observations. Multiple linear regression analysis was used to test hypotheses for panel data. The findings of the tests reveal that derivative ownership, leverage, and tax avoidance all have a detrimental impact on earnings management. Earnings management is not carried out when a corporation has derivative instruments, excessive debt levels, and tax avoidance activities. This report advises that the Financial Services Authority monitor earnings management actions that are damaging to shareholders' interests.

Keywords: Derivatives, Leverage, Tax Avoidance, Earnings Management

1. Introduction

A company's financial statements must include information regarding the company's financial performance over a certain period (Dechow et al., 2010). Net income represents the company's financial performance. It means the organization's current and potential future performance (Dechow & Schrand, 2004). The manager appointed by the principal has direct control as a shareholder representative in implementing company operations. Shareholders as principles and management as agents sometimes have different goals in managing the company, so there will be an agency problem (Lambert, 2001). Managers can take some action that

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contains earnings, making it irrelevant for decision-making. Earnings management is choosing certain accounting policies to increase or reduce profits for specific purposes (Scott, 2015).

One of the earnings management actions is discretionary accruals with adjustments recognized for accrual transactions so that accounting profit changes without affecting operating cash flow (Jones, 1991). Earnings management actions can use accrual techniques or real activities (Scott, 2015). In the accrual technique, earnings management consists of non-accrual and accrual discretionary. Accrual discretionary is an accrual transaction that management can control. The previous study discussed accruals discretionary and the methods to classify between non-accruals discretionary and accruals discretionary (Dechow et al., 1995; Kothari et al., 2005).

Earnings quality is important in evaluating a company's financial performance, but financial statement users often overlook it. Companies with high earnings quality have earnings stability, persistence, and variability, allowing them to report earnings that reflect actual earnings and predict future earnings (Beneish & Nichols, 2005). Profitability can be increased by providing more information on the company's financial performance elements crucial to decision-making (Dechow et al., 2010). Earnings that accurately reflect economic events and current economic conditions demonstrate the quality of financial statements (Yohan, 2017).

Financial statements information is a reference that both small and large companies commonly employ to describe a company's performance and is useful for making decisions for investors, creditors, and management. It should be relevant because relevant information is the quality of information from financial statements that can describe the firm value, which is useful for influencing decision-making (Kargin, 2013). There are various examples in Indonesia affecting earnings quality. PT Garuda Indonesia, Tbk reported a net profit of US$ 809 thousand in 2018, a

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considerable fall from the previous year's earnings (CNN Indonesia, 2019). In 2017, PT Garuda Indonesia, Tbk, recorded a loss of US$ 216.58 million. The financial statements were audited with an unqualified opinion, but the dramatic increase was caused by earnings management, resulting in financial statement misinformation (CNN Indonesia, 2019).

A similar case occurred at PT Kimia Farma, where PT Kimia Farma Tbk's net income in 2001 was reported as too large (Syahrul, 2003). Net income was Rp. 132 billion was considered to contain elements of earnings management (Syahrul, 2003). Information about earnings quality is needed by investors, creditors, and other users of financial statements (Beneish & Nichols, 2005). Earnings data is one of the key tools investors and managers use in discovering and analyzing investment possibilities (Bushman & Smith, 2003). Investors also employ earnings to find pertinent information that explains the company's net profit pattern (Francis et al., 2004). If financial information cannot reflect the company's actual situation due to earnings management actions, stakeholders will be mistaken in making decisions. Many factors influence the company's earnings management.

Earnings information that is not given following actual conditions might be damaging to shareholder decision-making. Managers within the company have greater information than shareholders in the agent-principle relationship (Jensen & Meckling, 1976). Furthermore, managers use accrual procedures to influence financial statement information (Scott, 2015). If the manager has conflicting interests, the information reported in the financial accounts will be skewed in shareholder decision-making. Even if no financial accounting principles are violated, earnings management can impair the quality of earnings and be negative to shareholders (Amin & Firmansyah, 2023; Jadi et al., 2021). As a result, manager reviews of earnings management actions must be studied further.

The accrual policy chosen by the manager can be related to other manager

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policies. Managers can manage earnings to maintain a certain profit value to ensure the policy is risk-free (Firmansyah & Suhanda, 2021; Prakosa et al., 2022). One factor influencing managers' decisions to manage earnings is the ownership of derivative instruments as hedging instruments. Barton (2001), Choi et al. (2015), Oktavia & Martani (2013), dan Pincus & Rajgopal (2002) suggested that the relationship between ownership of derivatives as hedging and discretionary instrument accruals has a negative relationship due to hedging. Derivatives and earnings management are substitute activities (Barton, 2001). If the company has the motivation to stabilize earnings by reducing its volatility, management can hedge and perform earnings management techniques. However, Huang et al. (2017) found that using derivatives by companies in developed countries can reduce firm risk, but this condition may not occur in developing countries such as Indonesia. Tests of derivative ownership on earnings management are rarely carried out, especially after adopting IFRS. Therefore, it needs to be re-examined.

Earnings management may also be influenced by company leverage. Alternative funding for companies other than selling shares in the capital market is through external financing in the form of debt. The company will attempt to pay off debts to maintain a good reputation with creditors. The leverage ratio is used to assess the acquisition of company assets through debt (Brigham & Houston, 2019).

Asitalia & Trisnawati (2017), Guna & Herawaty (2010), and Natasha & Bangun, 2020) found that leverage is negatively associated with earnings management. Fandriani & Tunjung (2019), Naftalia & Marsono (2013), and Pramesti & Budiasih (2017) concluded that leverage is positively associated with earnings management. Chandra & Djashan (2018), Fadlli & Khairunnisa (2020), and Kodriyah & Fitri (2017) suggested that leverage is not associated with earnings management. The existence of differences in the results of previous tests encourages testing of

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leverage on earnings management needs to be reconducted.

Tax avoidance activity is a form of manager strategy in tax planning (Febrian & Firmansyah, 2022; Purwaka et al., 2022). Through tax avoidance, managers attempt to save on the tax expenses paid to the government. Tax avoidance is usually carried out by earnings management, so that tax avoidance activities can indicate earnings management carried out by managers.

Antonius & Tampubolon (2019), Jadi et al. (2021), Maysani & Suaryana (2019), and Saksessia & Firmansyah (2020) found that tax avoidance is positively associated with earnings management. However, Ayem & Ongirwalu (2020) concluded that tax avoidance is not associated with earnings management

This study aims to examine the impact of the independent variables, derivative ownership, leverage, and tax avoidance, on earnings management simultaneously. In contrast to previous research, this study is significant due to the scarcity of research on the effects of derivative ownership, leverage, and tax avoidance on earnings management, especially after adopting IFRS in Indonesia. This study is expected to add to the accounting literature on the factors influencing earnings management, especially in Indonesia. In addition, this research is also expected to be used by the Indonesian Financial Services Authority in supervising earnings management activities by listed companies to protect investors.

2. Literature Review

According to agency theory, a company that separates ownership and management activities may face agency conflicts (Jensen & Meckling, 1976). If it relates to agency theory, there is a relationship between shareholders as principles and managers as agents who operate the company in this situation. The manager oversees operational activity and is more knowledgeable about the organization than stockholders (Jensen & Meckling, 1976). Managers tend to maximize their prosperity, but thus shareholders must minimize agency

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costs resulting from agency conflicts and asymmetric knowledge.

According to Scott (2015), earnings management is a manager's approach to accounting policies or decisions that alter the value of reported earnings to achieve certain goals. Opportunistic and motivational signaling motivate earnings management actions (Beaver, 2002). The manager takes the measures with opportunistic motivation. It denotes that the manager is aggressive in accounting to maximize earnings. Managers' desire to receive bonuses if the company performs well drives an opportunistic basis.

According to the signaling motivation, managers undertake earnings management to show good financial information that is supposed to convey a signal of prosperity to shareholders. Profit reports that are increasing and stable can indicate health. According to Penman & Zhang (2002), sustainable earnings are high-quality profits forecasting future earnings, then described as earnings persistence (Dechow & Dichev, 2002; Francis et al., 2004; Sloan, 1996). Meanwhile, the signaling reason argues that earnings management is undertaken by managers to show positive financial information and is believed to convey a signal of prosperity to shareholders (Penman & Zhang, 2002). Profit reports that are comparatively increasing and stable can imply well-being.

Furthermore, ownership of derivatives as hedging instruments helps reduce earnings volatility; this is the same as the goal of earnings management (Hairston & Brooks, 2019). Hedge accounting reduces earnings volatility and ensures stable earnings by reporting losses or gains on hedging instruments.

Barton (2001), Choi et al. (2015), Oktavia & Martani (2013), and Pincus & Rajgopal (2002) suggested that the relationship between ownership of derivatives as hedging and discretionary instrument accruals has a negative relationship. Hedge and earnings management is an act of replacement or substitution as a company effort to make

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company earnings look better (Barton, 2001). Hedging transactions are not fully effective because companies cannot protect all fluctuating prices, and managers will make earnings management decisions for things that cannot be hedged (Pincus & Rajgopal, 2002).

The manager's derivative ownership policy is intended to stabilize profits, particularly regarding hedging actions. In the meanwhile, earnings management is employed to reduce earnings volatility. As a result, managers select the policy that is most effective in stabilizing corporate profits.

H_1: Derivatives ownership is negatively associated with earnings management.

Managers will carry out earnings management to make a good image and then attract investors to invest; the manager's action is to stabilize earnings because managers intend to reveal that the company under their management has low risk and a good opportunity for investors. One of the statistics that might demonstrate how much a corporation is funded by debt is the leverage ratio. The higher the leverage ratio, the more debt-financed the company is. It suggests that the risks incurred by shareholders and creditors are increasing.

Fandriani & Tunjung (2019), Naftalia & Marsono (2013), and Pramesti & Budiasih, 2017) concluded that leverage increases earnings management activity. Managers strive to keep the company healthy by sustaining consistent earnings. Managers in charge of earnings management carry out these actions. This effort is used to persuade creditors of the firm's financial situation so that creditors will lend money to the company in the form of debt.

H_2: Leverage is positively associated with earnings management.

Tax avoidance is an indication of how managers handle earnings. Managers use earnings management to avoid taxes in the context of tax planning. Antonius & Tampubolon (2019), Jadi et al. (2021), Maysani & Suaryana (2019), and Saksessia & Firmansyah (2020) found that tax avoidance is positively associated with earnings management. Managers engage in tax avoidance by using

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regulatory gaps to reduce the tax burden paid to the government. Conversely, managers use an accrual policy to influence the numbers in the financial statements. One of the reasons managers dodge taxes is to save money.

H_3: Tax avoidance is positively associated with earnings management.

3. Research Methods

This study was conducted using quantitative research methods. This study's population consists of manufacturing companies listed on the IDX and have derivative instruments from 2018 to 2021. Purposive sampling was utilized, and the following criteria were used:

Table 1
Determination of the Research Sample

Description	Amount
Manufacturing company registered December 1, 2021	193
Companies do not have derivative instruments	(174)
Companies have derivative instruments 2018 - 2021	19
Outlier Data-Negative ETR	(1)
The number of companies that can be used in this study	18
Number of years of research	4 years
Total sample	72

Source: data processes (2022)

This study employs the dependent variable: earnings management. While derivative ownership, leverage, and tax avoidance are independent variables in this study. Earning management is calculated by Kothari et al. (2005). Total accrual is derived from net income minus cash flow from operations. The accrual calculation is discretionary and calculated each period for a sample of selected companies. The absolute value of the discretionary accruals is used to determine how accrual earnings management actions reduce and increase earnings, as Dzulfikar & Firmansyah (2022).

With the following formula:

$$\frac{\text{Accrual}}{\text{TA}_t - 1} = \beta 0 \left(\frac{1}{\text{TA}_t - 1}\right) + \beta 1 \left(\frac{\Delta\text{REV}_i}{\text{TA}_t - 1}\right) + \beta 2 \left(\frac{\text{PPE}_i}{\text{TA}_t - 1}\right) + \beta 2\text{ROAi} + \varepsilon$$

Every year, the value of discretionary accruals is calculated using the residuals from the regression equation above. Derivatives ownership in the sample companies does not always exist in every period. From the data collection, derivative ownership can be grouped into derivative assets and liabilities. Derivative calculations

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use the absolute value of the fair values of derivative assets less the fair value of derivative liabilities as Firmansyah et al. (2020), Firmansyah & Purnama (2020), and Oktavia & Martani (2013).

$$\text{Deriv} = \frac{(\text{absolute fair value of derivatives})}{\text{Total Asset}_{t-1}}$$

The measure of leverage in this study is the percentage ratio of the company's total debt and assets, as Annida & Firmansyah (2022). The debt-to-assets ratio (DAR) is one of the leverage ratios that compare the composition of total debt, both short-term and long-term, with the company's total assets. The greater the DAR, the greater the company's costs to outsiders (Brigham & Houston, 2019).

$$\text{Debt to Asset} = \frac{\text{Total Debt}}{\text{Total Asset}}$$

Tax avoidance is a variable that measures company management policies in tax avoidance using the Effective Tax Rate (ETR). ETR calculates the company's effectiveness in comparing the tax expenses with total net income as the basis for imposing a corporate income tax. The smaller the percentage of ETR, the better the company's performance in management and the effectiveness of paying taxes. The ETR formula follows the proxy employed by Annida & Firmansyah (2022) and Rahma & Firmansyah (2022)

$$\text{ETR} = \frac{\text{Tax Expense}}{\text{Earning Before Taxes}}$$

Tax avoidance is calculated by multiplying -1 as Annida & Firmansyah (2022) and Rahma & Firmansyah (2022). This study employs various linear regression analysis techniques for panel data to test the hypothesis. The multiplier followed the Chow, Lagrange, and Hausman tests to obtain the best model. This study uses the following models:

$$DA_{it} = \alpha_0 + \beta_1 DERIV_{it} + \beta_2 LEV_{it} + \beta_3 TAXAVOID_{it} + \varepsilon_{it}$$

Where DA_{it} is earnings management in year t for the company i; $DERIV_{it}$ is derivative ownership in year t for the company i; LEV_{it} is debt ratio to

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assets in year t for the company i $TAXAVOID_{it}$ is tax avoidance in year t for the company i.

4. Results and Discussions

4.1 Results

The following are the results of descriptive statistical tests, which are presented in the table below:

Table 2.
Table of Descriptive Statistics

Variable	Mean	Med.	Std.Dev.	Min.
DA	0.049	0.031	0.047	0.002
DERIV	0.003	0.0007	0.007	0.000
DAR	0.502	0.512	0.168	0.010
TAXAVOID	-0.296	-0.245	0.283	-1.545

Source: processed data

Furthermore, based on the Chow test, the Lagrange test Multiplier, and the Hausman test, the best model for hypothesis testing is using common effect models. The summary of the results of hypothesis testing is as follows:

Table 3.
Summary of Hypothesis Testing Results

Variable	Coeff.	t-Stat	Prob.	
C	0.066	5.134	0.000	***
DERIV	-0.745	-2.313	0.012	**
LEV	-0.058	-2.975	0.002	***
TAXAVOID	-0.031	-2.084	0.020	**
R^2	0.227			
Adj. R^2	0.193			
F-stat.	6.674			
Prob(F-stat.)	0.000			

Source: data processed (2022)

Note:
***) significant at the 1% level, **) significant at the 5% level.

4.2 Discussion

4.2.1 The effect of derivative ownership on earning management

This study finds that derivative ownership is negatively associated with earnings management. This finding is consistent with research by Barton (2001), Choi et al. (2015), Oktavia & Martani (2013), and Pincus & Rajgopal (2002), who discovered a negative relationship between derivatives ownership as hedging and discretionary accruals because hedging and earnings management are acts of replacement or substitution as a company effort to beautify company earnings (Barton, 2001).

The market in developed countries employs financial derivatives for hedging in assessing the persistence of operating cash flows of the companies. In contrast to developing countries, where the market overestimates the persistence of the two,

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the market for companies with speculative derivatives tends to be undervalued (Oktavia et al., 2019). Derivative transactions are designed to manage risk. Rusting with financial derivatives reduces earnings volatility; companies do not need discretionary accruals to reduce income volatility (Oktavia et al., 2019). The manager's derivative ownership policy is intended to stabilize profits, particularly regarding hedging actions. In the meanwhile, earnings management is employed to reduce earnings volatility. As a result, managers select the policy that is most effective in stabilizing corporate profits.

4.2.2 The effect of leverage on earnings management

According to the finding of this study, leverage is negatively associated with earnings management. This result is consistent with Asitalia & Trisnawati (2017), Guna & Herawaty (2010), and Natasha & Bangun (2020). However, this result is different from Chandra & Djashan (2018), Fadlli & Khairunnisa (2020), Fandriani & Tunjung (2019), Kodriyah & Fitri (2017), Naftalia & Marsono (2013) and Pramesti & Budiasih (2017).

Managers that have more debt tend not to do more earnings management. Although creditors do not pay much attention to managers' earnings management efforts, managers believe that creditor support can improve the company's ability to meet its debt funding sources.

Furthermore, managers must preserve creditors' trust to persuade them that the accounting information in the financial statements is not biased. Managers also do not utilize earnings management to secure new sources of debt from creditors or draw directors' attention. Precise earnings management actions might encourage organizations to encounter financial issues if true financial information is not presented (Dzulfikar & Firmansyah, 2022).

4.2.3 The effect of tax avoidance on earnings management

This study finds that tax avoidance is negatively associated with earnings management. This finding is

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not consistent with Antonius & Tampubolon (2019), Ayem & Ongirwalu (2020), Jadi et al. (2021), Maysani & Suaryana (2019), and Saksessia & Firmansyah (2020). The outcome of this test reveals that there is a trade-off between tax avoidance and earnings management. When tax avoidance is carried out, managers do not carry out earnings management due to variances in tax legislation in Indonesia.

Furthermore, even if avoiding taxes does not contravene regulatory restrictions, it is thought to align the interests of shareholders. Meanwhile, profits management actions tend to produce skewed information that shareholders use to make decisions. Thus, this study demonstrates that shareholders or investors respond favorably to managers' tax evasion efforts (Irawan & Turwanto, 2020; Widodo & Firmansyah, 2021). Managers' tax avoidance operations can be viewed as aligning shareholders' interests, particularly in assisting the development of shareholder wealth.

$$FIN\_PER = 1{,}103 + 0{,}922\ ENV\_PER + 0{,}755\ ENV\_DCL + e$$

5. Conclusions

This study finds that derivatives ownership, leverage, and tax avoidance decrease earnings management. When a corporation has derivative instruments, earnings management actions are not carried out concurrently. Derivatives ownership is supposed to promote profit stability, whereas earnings management methods are used to prevent earnings volatility. Managers are more likely to offer accurate financial data when a company's debt is larger. Managers also consider the possibility of financial trouble if they disguise their financial situation to get debt finance from creditors. Tax evasion is unrelated to earnings management activities. Aside from the regulatory disparities between Indonesian tax legislation and financial accounting standards, tax evasion operations are typically carried out by management to align their interests with those of shareholders. Meanwhile, earnings management is viewed as antithetical to shareholder interests.

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Because of limitations in determining the number of samples of companies with derivative instruments from the manufacturing sector in this study, the testing results do not accurately describe the conditions of various other sectors in Indonesia. Future research could make better use of non-financial sector data to describe conditions. According to this study, companies with derivative instruments and leverage should be a concern for investors, indicating that the management of these companies can manage earnings. This study suggests that the Indonesian Financial Services Authority needs to oversee earnings management actions by listed companies that can be detrimental to the interests of shareholders.

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