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REAL EARNINGS MANAGEMENT AND PROFITABILITY ON COMPANIES LISTED ON JAKARTA ISLAMIC INDEX

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ABSTRACT
Objective of this research is to find the influence of Real Earnings Management (Operating cash flow, production costs, and cost Discretionary) towards the profitability of ROA in the companies listed on the Jakarta Islamic Index of period 2012-2017. The sampling method using purposive and analysis of research data using multiple regression analysis. Operating cash flow (CFO) gives a positive and significant effect on performance of the company (ROA). The production costs (PROD) and the cost of Discretionary (DISEXP) are not significant but giving positive effects on performance of the company. This shows that the Real Earnings Management in production costs and the cost of discretionary does not affect the company's Profitability at the company indexed in JII.

Keywords: Cash Flow; Operating Costs Discretionary; Production Costs; Real Earnings Management; ROA

INTRODUCTION

A conflict of interest between principal and management is a common problem experienced by a company that is registered in a stock exchange, this condition is called earnings management. The conflict of interest causes asymmetric information between the owner and management. As a result, the management is able to implement accounting practice that will give itself a profit oriented on the maximum performance. According to a study of Graham et al. (2005), it gave an empirical evidence that managers tend to conduct real earnings management rather than accrual earnings management. Real earnings management is more difficult to detect because it is similar with the optimum business decision. Roychwodhury (2006) found that management will make real earnings management if the accrual earnings does not reach the determined goal and the real earnings management activities can be performed without waiting the end of period as in the accrual earnings management activities. Therefore, real earnings management becomes the first priority than detectable accrual earnings management.

Profit manipulation through real earnings management is performed by manipulating sales and production excessively and decreasing discretionary cost that will give direct effect on the cash flow of the company. It is hard to detect by investors, auditors, regulators, and related parties rather than by the accrual earnings management that is easily understood by auditors. Some revealed cases are Kimia Farma Tbk that made an alleged markup of net profit on its financial report in 2001 (Tempo Newspaper, 2002). In reality, the company had hidden the losses suffered for two years in the period 2001-2002 when the company passed the selection of JII index. It was also done by Indofarma Tbk. that hide its losses suffered for the period of 2001-2002.

The activities of real earnings management has been attempted to prove its impact to profit through the previous studies, such as Yusnita et al (2015), Nanik (2016), and Eva (2015) showed that the real earnings management over operational cash flow, production cost, and discretioner cost simultaneously affects the performance of the company. In contrast, Fitriyani et al (2014), Herlina (2014), Eka (2012), and Darma (2017) found that there is no effect of real earnings management to profitability.

Based on the previous studies, objects of the study are public companies listed in Indonesian Stock Exchange, one of them is Jakarta Islamic Index in which the companies registered in the index are companies in the category of Islamic sharia without usury element, and the corporate capital is also not the majority of debt. The researchers tried to

observe the activities of real earnings management in Jakarta Islamic Index. They determined the purpose of the study: The Effect of Real Earnings Management to Profitability of Companies listed in Jakarta Islamic Index (JII) on period 2012-2017.

LITERATURE REVIEW

Agency theory relates to the solution of two problems occurring in the relationship between agency and management. The first problem is an agency problem occurred when (a) the expectations of the owner and agent are different and (b) the owner finds difficulty to verify whether the agents routinely do their tasks or not. The problem here is when the owner cannot verify that the agent has behaved appropriately. The second is when the owner and agent have different reaction to risk sharing. The problem is that the principal and his agent might prefer different actions due to differences in risk preferences. It might cause the agent or management to perform earnings manipulation through earnings management.

Agency theory analyzes and solves two problems that often occur in a relationship between principal (owner/stakeholders) and their agent (management). Based on this condition, it is required a good management system in the company called *Good Corporate Governance* (GCG). According to Rustiarini (2010) in Jeffrio (2011), aspects of Corporate Governance such as ownership, managerial, institutional ownership, independent commissionary part, and the number of audit committee members are seen as the accurate control mechanism to minimize conflict with the agencies.

According to Scott (2009), earning management is an action of management to choose the accounting policy from a certain standard for maximizing the prosperity and market value of the companies. Whereas the opinion of Schipper (1989), earnings management is related to efforts to manage the income and profits for certain interests based on economic factors.

The main motivation for Real Earnings Management is timing of earnings management in which it is conducted any time during the accounting period. This manipulation of real activity is more difficult to detect because it cannot be distinguished from optimal business decision. Actions taken in the current period aimed at increasing this profit will have a negative effect on cash flow in the coming period. Production that exceeds the normal production results in excess inventory that should be sold in the next period and drives the high cost of maintaining inventory of the company.

Islam teaches human beings to balance their lives. One of balances meant by the Quran is balanced in finding provisions to reach the happiness of living in the world and hereafter. Therefore, Quran requires human beings to work. In a company work should be left to experts and work with their respective circumstances. Thus the managers must have the ability and must be precise in working in accordance with the content of QS.Al Isra':84.

Say: "Each person does according to his own circumstances. Then your Lord knows who is more right in the way" (QS.Al Isra:84).

In carrying out his duties a manager should not be too arrogant in doing his work to avoid undesirable things. A manager in his job other than in accordance with ability must maintain the mandate given with full responsibility and must not betray as explained in the QS Al Anfal:27:

"O you who believe, do not betray Allah and the Prophet (Muhammad) and (also) do not betray the mandates entrusted to you, while you know" (QS Al Anfal:27).

Manipulation of real earnings management activities is defined as management actions that deviate from normal business practices, which are carried out with the main objective to meet certain thresholds of targets determined based on the definition of Roychowdhury (2006). Rowchowdhury (2006) found evidence that companies provide price discounts to increase sales, engage in overproduction to reduce cost of goods sold an continue to control discretionary spending to increase margins. Based on the above, there are three ways to conduct Real Earnings Management activities, among others, by increasing sales, overproduction and reduction in descriptive costs.

Roychowdhury (2006) found a negative relationship between institutional ownership and real manipulation activities, debts, stock, account receivable, and growth opportunities are positively correlated with real activities manipulation and real activities manipulation is carried out to avoid negative annual estimation errors, managers increase profits to avoid reporting containing losses and estimation errors, companies that have small positive earnings reports and small positive estimation errors do earnings management through real activities.

Kinney and Wempe (2004) documented that the decision to adopt just-in-time (JIT) practices – fundamental operational decisions – is influenced by the relationship of the company's LIFO reserves with income average, debt agreements, and tax incentives. Mande et al (2000) documented a substantial reduction in R&D costs in Japanese companies during the 1990s recession. These companies, which have a reputation for long-term R&D vision, show behavioral signals of increased myopic income. Evidence shows that this cost cutting is a product of earnings management, not an optimal business decision.

Hribar et al (2006) investigated repurchase stock as a tool to increase earnings per share. While most earnings management studies focus on earning, these researchers have investigated whether managers increase EPS by decreasing the donominator (number of shares). They found an unexpectedly large number of share repurchase among companies that would have missed the EPS forecast without repurchase.

HYPOTHESIS

The first hypothesis in this study formulates the previous study of Oktorina and Hutagaol (2008) stated that companies implemented Real Earnings Management through operating cash flow have higher profitability than those suspected of not manipulating real earnings management through operating cash flow. Then the researchers formulated the hypothesis as follows:

H1: Operating Cash Flow has a positive effect on profitability in companies indexed in JII.

Manipulation of production cost uses an over-production strategy that is by dividing fixed overhead costs for a larger number of units, then net income will increase along with a decrease in cost per unit in the current period. Thomas and Zhang (2002) found that overproduction would reduce the cost of production reported, which is certainly different from real economic conditions. Based on this, the researchers hypothesized as follows:

H2: Production costs give positive effect to profitability on companies registered in JII.

Whereas the study of Cohen and Zarowin (2010) found companies that decrease their discretionary costs to rise their profits. The profit will increase investor interest in buying company shares. Performance indicators through profit are the main preference for investors' considerations in investing if costs decrease then profitability performance will increase. Based on this condition, researcher proposes the following hypothesis:

H3: Discretionary cost gives positive effect on profitability on companies listed in JII.

METHODS

The study used quantitative method. The population in the study was 56 companies listed in JII since 2012 until 2017. This study used purposive sampling so that the samples obtained were 13 companies. Based on the criteria determined for selecting the samples, the companies selected are Astra Agro Lestari Tbk; AKR Corporindo Tbk; Astra International Tbk; Bumi Serpong Damai Tbk; Indofood CBP Sukses Makmur Tbk; Indofood Sukses Makmur Tbk; Kalbe Farma Tbk; Lippo Karawaci Tbk; PP London Sumatra Indonesia Tbk; Semen Gresik (Persero) Tbk; Telekomunikasi Indonesia (Persero) Tbk; United Tractor Tbk dan Unilever Indonesia Tbk.

As discussed earlier, this study attempts to investigate the effect of Real Earnings Management with all its Proxies that can affect the Company's Profitability where ROA is a proxy. The independent variables used in this study are earnings management through manipulation of real activities with abnormal proxies of CFO, abnormal discretionary expenses, and abnormal production costs, where indicators of independent variables are measured by the following indicators:

1. Abnormal Operational Cash Flow

Abnormal operating cash flow is obtained from the difference in the value of actual operating cash flow scaled by total assets one year before the test less the normal operating cash flow which is calculated using the estimated coefficient from the regression equation (1).

$$CFO_t/A_{t-1} = \alpha_0 + \alpha_1(1/A_{t-1}) + \beta_1(S_t/A_{t-1}) + \beta_2(\Delta S_t/A_{t-1}) + \epsilon_t \quad (1)$$

2. Abnormal Discretionary Expenses

Abnormal discretionary costs are obtained from the difference in value of actual discretionary costs which scales with total assets one year before testing reduced by normal discretionary costs calculated using the estimated coefficients of the regression equation (2).

$$DISEXP_t/A_{t-1} = \alpha_0 + \alpha_1(1/A_{t-1}) + \beta(S_{t-1}/A_{t-1}) + \epsilon_t \quad (2)$$

3. Abnormal Production cost

Abnormal production costs are obtained from the difference in value of actual production costs scaled by total assets one year before testing reduced by normal production costs calculated using the estimated coefficient of the regression equation (3).

$$PROD_t - A_{t-1} = \alpha_0 + \alpha_1(1/A_{t-1}) + \beta_1(S_t/A_{t-1}) + \beta_1(\Delta S_t/A_{t-1}) + \beta_1(S_{t-1}/A_{t-1}) + \epsilon_t \quad (3)$$

Description:

CFO_t = operational cash flow of company i in the year t
$DISEXP_t$ = discretionary costs in year t
$PROD_t$ = production costs in the year i, namely cost of goods sold + change in inventory
A_{t-1} = total assets in the year t-1
S_t = sales in year t
ΔS_t = sales in the year t minus sales in the year t-1
ΔS_{t-1} = change in sales in the year t-1
α_0 = a constant
ϵ_t = *error term* in the year t

The data analysis technique used in this study is multiple regression analysis. Regression equation models to test the hypothesis of this study are as follows (equation 4):

$$ROA = \alpha + \beta_1 AK + \beta_2 BP + \beta_3 BD + \epsilon \quad (4)$$

Description:

ROA = Return On Asset
AK = Real Earnings Management on Operational Cash Flow
BP = Real Earnings Management on Operational Costs

BD	= Real Earnings Management on Discretionary Costs
α	= Constant
$\beta_{1,2,3}$	= Regression Coefficient on each Independent Variables
ϵ	= error term

RESULTS AND DISCUSSION

Based on the previous studies, they showed that CFO, DISEXP, and PROD have significant effects on ROA. It means that the level of evaluation of ROA is influenced by the level of cash flow, discretionary costs and production costs. The results obtained by 12.4% are influenced by real earnings management variables (CFO, DISEXP, and PROD) while the remaining 87.4% are influenced by other factors. In the research that has been done, Real Earning Management as an independent variable consisting of operating cash flow activities, discretionary expenses, and production costs are measured by one dependent variable, namely ROA. Based on tests that have been conducted by researchers, the result is that only the Operating Cash Flow Activity variable has a significant effect on ROA. The following is a full discussion on each of these variables.

Through the statistical tests that have been carried out give results that the Operating Cash Flow variable (CFO) has a significance value of 0.026<0.05, so it can be interprete that the Operating Cash Flow has a significant effect on ROA for companies listed on the Jakarta Islamic Index (JII). This proves that in improving performance within a company, the management has a high motivation to conduct Real Earning Management activities in Operating Cash Flow. The results of research conducted contrary to this research namely Eka (2012) showed there was no effect of Real Earning Management on profitability in LQ 45 companies as well as research conducted by Wijayanti (2014) which obtained results if the research with a real earnings management approach through operation cash flows have no effect on performance in a company.

In contrast to research conducted by Yusnita et al (2015) which showed the results that real earnings management through operating cash flow has a significant effect on company performance. The effect of production costs on ROA through the test of production cost variables produces a significant of 0.652>0.05, so it can be interpreted that the variable production costs do not have a significant effect on ROA in companies listed on the Jakarta Islamic Index (JII). It means that if management shows less performance in real activities on production costs, due to the lack of emphasis made by a manager in determining the cost of production to produce goods with large quantities so that they are unable to reduce production costs resulting in quite low profits. The results of this study contradict the research conducted by Mulyadi (2015) which obtained results if real earnings management through production costs had a significant effect on company performance, whereas research conducted by Riska (2014) which found results of real earning management practices through production costs had no significant effect for a performance.

The effect of the discretionary costs on ROA was tested through statistical tests that have been carried out giving the result that the variable discretionary costs (DISEXP) variable has a significance value of 0.657>0.05, so it can be interpreted that the DISEXP variable has no significant effect on ROA on companies listed on the Jakarta Islamic Index (JII). This means that if profits are managed through discretionary costs are still in a poor condition. But if management wants to show good performance, management can do the expected profits by reducing advertising costs, research costs, and the company development to obtain the desired profit. The result of the study was supported by a study conducted by Koyumirza (2011) with a conclusion that real earnings management through discretionary costs does not affect to the company performance. In the contrary with the study of Yusnita (2015) stated that there are effects of Real Earnings Management on discretionary costs to the company performance.

A simultaneously test result produces independent variables consisting of Cash Flow (CFO), Excessive Production (PROD), and Discretionary Expenses (DISEXP) affect

profitability with a contribution of 0.020<0.05. Although the R square test results showed that the variables included in the study were 12.4% which means the independent variable had a low influence, the magnitude of effect caused by other variables was 87.6%.

CONCLUSION

Based on the result of the study conducted on 13 manufacturing and service companies indexed on JII and listed on BEI in the period of 2012-2017, it was found negative influences between Real Earning Management and Profitability in the companies. Based on the study, it can be concluded that companies which conduct Real Earning Management will reduce their performance. According to the partial results, Operational Cash Flow (CFO) has significant influence to company profitability with significant value of 0.026<0.05 meaning that in a company a manager makes a sales manipulation by giving bonus that influence the cash flow in his company. While excessive production (PROD) has no significant effect on company profitability with a significance value of 0.652>0.05. That is, the management does not emphasize or determine the cost of production to produce goods with large quantities, so that it is unable to reduce production costs resulting in the profits obtained. The reduction in discretionary expenses (DISEXP) did not significantly influence the company's profitability with a significant value of 0.657>0.05. It means that suppressing the advertising cost, research, and company development in obtaining profits is still in a bad condition.

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