

Earnings Management Through Classification Shifting: Evidence In Indonesia, Singapore, And Malaysia

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Abstract - The extent of information about accounting figures and its correlation with accounting standards provoke controversy among academicians nowadays. A low level of information asymmetry among investors, management, and other users represents high quality financial statements which is captured on proper earnings management. The issue of earnings management through classification shifting is closely related to the fact revealed by researchers, i.e. that analysts and investors are paying greater attention to core earnings, whether it can mislead about the ability to estimate the income. In this research, the sample consisted of extraordinary items of all companies listed on the stock exchange in each country.

Keywords: *earnings management, classification shifting, special items, other comprehensive income.*

I. INTRODUCTION

This research referred to inductive research undertaken by Jones and Smith (2011), Bamber (2010), Barth et al. (2008), and Burgstahler et al. (2002) to achieve research objectives. Those four studies tempted that earnings quality is one of the indicators that lead to increased quality of financial statements in a transitory account. These indicators can be seen from the relevance of values, predictive values, and earnings persistence.

According to Institution of Global Board, Financial Accounting Standards Board (FASB), and International Accounting Standards Board (IASB), entities are expected to gather information that fully reflects financial statements even though extraordinary items are not integrated into the net income of such financial statements. Thus, other comprehensive income and special items are not derived from the company's main operation.

Burgstahler et al. (2002) and Bamber et al. (2010) reveal that special items (SI) and other comprehensive income (OCI) affect entities' share price due to market responses. It gets higher when entities report their extraordinary items than when they do not. It also illustrates that the advantage of extraordinary items is their significant value relevance.

Jones and Smith (2011) find the evidence that special items (SI) and other comprehensive income (OCI) contain a relevance value, but SI gain and losses exhibit zero persistence (e.g. transitory), while OCI gain and losses exhibit negative persistence (change periodically). The result also reveals that OCI and SI have a strong predictive value for net profit and future cash flows. It will provide earnings information whenever it triggers the management to manage earnings.

This research focused on measurement of earnings management using an instrument developed by McVay (2008). Shifting classification as a measuring tool was used to test the extent to which managers carry out earnings management by shifting expenses down (or shifting revenue up) in order to improve their performance report. The research is expected to provide references in particular as to (i) accounts that are often overlooked by investors and analysts, special items, and other comprehensive income which are strategic accounts for shifting; (ii) measures of earnings management, particularly classification shifting towards special items accounts; and (iii) consideration for policy makers throughout the world, especially Indonesia, Malaysia, and Singapore, to use financial standards in determining the most appropriate standards.

II. THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT

A. Earnings Management

Earnings management can be defined as an intervention in an external financial reporting process with a specific purpose, i.e. personal gain (Schipper, 1989). It may also refer to the process of beautifying financial statements, especially figures at the bottom or "bottom-line earnings". In this research, earnings management was performed using the classification shifting model developed by McVay (2006).

Core earnings are of concern to investors in determining the extent of a company's ability to generate profits. Those account of transitory items lack serious attention, which in turn affect their relevance value, predictive value, and persistence. Determine the value of future earnings is vital, but the instrument needs further development. The measurement above was used to examine the number of company managers performing earnings management by shifting expenses down (or revenue up) in order to improve their company's financial statements.

B. Extraordinary Items

Special Items

APB Opinion No. 30 defines special items as items which are unusual (in nature) and rare (in frequency of occurrence). If there is an event or transaction that meets one of these requirements, it probably is presented along with revenue and expenses. Burgstahler et al (2002), suggests analysts and investors to attain more attention to core earnings than non-operating income because they have high persistence resulting from normal operations of the company. On the other hand,

non-core earnings contain unusual irregular items that are not repeated (non-recurring) under normal conditions.

These issues can be presented in two factors. First, the reporting of special items on annual report can cause bias, which basically is users' perception of financial statements regarding the results of operations (core earnings or profits), and the projection of the company's operations in the future. Second, controversy arises as to the ability to separate between events that originate from the company's normal operations and those that originate from outside the business (third parties).

Other Comprehensive Income

SFAS No. 115 defines other comprehensive income (OCI) as a change in gaining and losing which may be not realized until the realization occurs, and therefore it can be reported separately from the net income statement. OCI includes change of fair-value securities into available-for-sale (AFS) ones, adjustments in foreign currency exchange rates, e additional adjustments in pension debt and fair-value changes in derivative instruments classified as the cash flow hedge.

The change of standards from the rule-based to principle-based ones has significant effect on earnings quality, whereas the level of earnings management may reduce earnings quality. Other comprehensive income is one of the indicators of financial statements' increased quality. This indicator can be seen from the relevance of values, the predictive values, and earnings persistence.

The previous research relates earnings management with comprehensive income. Lin, Rong (2011) provides evidence that other comprehensive income/OCI has an important role in comprehensive income and is related significantly to earnings management. The previous study also provides evidence that many companies do not report other comprehensive income gains and losses (Bamber, 2010). This indicates that managers perform one of earnings management strategies by admitting, transferring or classifying some accounts of other comprehensive income.

C. Hypotheses Development

Earnings Management Using Classification Shifting

McVay (2006) examines the classification of items in the income statement as a profit management tool. McVay's previous research focuses on the use of special items, to conduct a test whether managers classify the core expenses as special items to improve core earnings or not. Research findings show that managers opportunistically change the core earnings into special items. Measurement of the above-mentioned special items then is also used by researchers to examine the accounts of other comprehensive income.

To prove classification shifting, this research focused on testing different expense allocations between core earnings and special items (SI) with core earnings and other comprehensive income (OCI). Studies conducted by Bamber (2010), Burgstahler et al. (2002), and those mentioned above have proven that classification shifting may occur when a company reports a loss in the transitory items account. Research by Barth (2008), Tandeloo and Vanstraelen (2005), Armstrong, et al (2010) find that the use of IFRS decreases earnings management and improves earnings quality. Therefore, researchers argue that IFRS manages to reduce the

possibility of earnings management. Based on the above arguments, the hypothesis to be tested is:

H1: Earnings management decreases during the classification of Other Comprehensive Income (OCI) compared to the classification of Special Items (SI).

To prove Hypothesis 1, this research tested Hypotheses H1a and H1b below, which are the detection of earnings classification obtained at the time of unexpected core earnings in year t is expected to increase when special items are recognized in year t . So the hypothesis to be tested is:

H1a: Special items in the current year is positively influenced by the unexpected core earnings in the current year.

Furthermore, to conclude that the change of classification shifting results from changes in real economic improvement, it is necessary to test whether an increase in core earnings in year t is the opposite (reverse) in year $t+1$ when core earnings are transferred to special items in year t and in year $t+1$. based on the foregoing, the hypothesis to be tested is:

H1b: The current year's special items negatively affect the next year's unexpected change in core earnings.

This test compared the classification of earnings that occurs in special items and other comprehensive income. McVay's measurement model carried back accounts of other comprehensive income (OCI) to obtain the results of earnings management through classification shifting based on IFRS standards, and the same test was also performed on accounts of other comprehensive income, resulting in hypotheses H1c & H1d as follows:

H1c: The current year's other comprehensive income is positively influenced by the current year's unexpected core earnings.

H1d: The current year's other comprehensive income is negatively influenced by the next year's unexpected change in core earnings.

III. RESEARCH METHOD

The research population was comprised on companies in three (3) countries with similar culture. The countries from which the research sample was obtained were classified using Hofstede Dimensions of National Culture. The research sample was chosen using a purposive sampling technique based on certain criteria. The sample and data were collected based on the following consideration.

A. Sample and Data

The research sample consisted of companies in countries with a high level of certainty, which are Indonesia (48), Malaysia (36), and Singapore (8). The sample is divided into two categories: companies that report special items (local GAAP) and companies that report other comprehensive income (IFRS).

The sample period for companies that use special items (local GAAP) was from 2001 until 2005, while for companies that use other comprehensive income (IFRS), it started from 2009 to 2013. The sample period from 2006 to 2008 were excluded from the sample to prevent big bath. Standard

adoption is not maximized and global economic instability may result in measurement bias.

Companies that publish financial statements with financial year ended on December 31.

The data needed were collected used Bloomberg that illustrate the research sample: listed companies from three countries in Asia (i.e. Indonesia, Malaysia, and Singapore) and Europe. Observations were classified into three groups, with the first group is the ratio of other comprehensive income to special items.

B. Classification Shifting Variable Measurement

Measurement of variables in this model aimed to test Hypotheses 1 and 2. The model used was the property model developed by McVay (2006) to examine the classification shifting-based earnings management mechanism.

1. Dependent variables

• Unexpected Core Earnings (Model 1)

Unexpected Core Earnings refers to the difference between the reported core earnings and the predicted core earnings. The following formula was used to calculate it:

$$UE_CE_t = \text{reported } CE_t + \text{predicted } CE_t$$

Reported CE_t refers to core earnings reported in the income report in t period, which was calculated using the following formula:

$$\frac{\text{Sales} - \text{COGS} - \text{Sales Cost, General, \& Administration}}{\text{Sales}}$$

Then, Predicted CE_t refers to predicted core earnings in year t and it was calculated using the coefficients of Equation 1 below to control economic performance such as macroeconomic and industry shocks. The following formula was used:

$$CE_t = \beta_0 + \beta_1 CE_t + \beta_2 ATO_t + \beta_3 ACCRUALS_{t-1} + \beta_4 ACCRUALS_t + \beta_5 SALES_t + \beta_6 NEG_ \Delta SALES_t + \epsilon_t$$

Variable Definition:

- CE_t = core earnings in t period
- CE_{t-1} = core earnings in $t-1$ period
- ATO_t = asset turnover ratio
- $ACCRUALS_t$ = operating accruals in $t-1$ period
- $\Delta SALES_t$ = percentage of change in t -period selling
- $NEG_ \Delta SALES_t$ = percentage of change in selling ($\Delta SALES_t$).

• Unexpected Change in Core Earnings (Model 2)

Unexpected Change in Core Earnings refers to the difference between the reported core earnings (reported change in core earnings) from year t to year $t+1$ and predicted change in core earnings (predicted change in core earnings) from year t to year $t+1$. The following formula was used to calculate it:

$$UE_ \Delta CE_{t+1} = \text{reported } \Delta CE_{t+1} + \text{predicted } \Delta CE_{t+1}$$

Reported ΔCE_t refers to reported change in core earnings from year t to year $t+1$, which was calculated based on Reported $CE_{t+1} - \text{Reported } CE_t$, while predicted ΔCE_{t+1} refers to predicted change in core earnings from year t to year $t+1$, which was calculated using the coefficients of Equation 2 below to control economic performance. The following equation was used:

$$\Delta CE_t = \phi_0 + \phi_1 CE_{t-1} + \phi_2 \Delta CE_{t-1} + \phi_3 ATO_t + \phi_4 ACCRUALS_{t-1} + \phi_5 \Delta ACCRUALS_t + \phi_6 \Delta SALES_t + \phi_7 NEG_ \Delta SALES_t + v_t$$

2. Independent Variables

Special items

Special items (SI) are special income (charge) after tax which are commonly not included in a company's net profit. They were calculated using the following formula:

$$\text{Special Items (SI)} = \frac{\text{Special items}_t \times (-1)}{\text{Sales}_t}$$

Other Comprehensive Income (OCI) was calculated using this formula:

$$\text{Other Comprehensive Income (OCI)} = \frac{OCI_t \times (-1)}{\text{Sales}_t}$$

C. Data Analysis Technique

This research employed multiple regression to analyze data and test hypotheses. Testing was carried out using three calculation processes. To test Hypothesis 1, the researcher tested the mean of discretionary accruals using accrual management proxy between periods using local GAAP standards with special items as the variable measured, which was then compared to IFRS standards with other comprehensive income as the variable measured.

Testing of Hypothesis 1 intended to examine whether shifting occurred in the report containing special items and other comprehensive income or not. The regression models of Equations 1 and 2 were used to calculate the mean of the independent variable coefficients between the periods using special items and the periods using other comprehensive income. A different statistical test, which was paired sample t -test. The following are equations used for calculating Hypothesis 1:

$$1a: UE_CE_t = \alpha_0 + \alpha_1 SI_t + \alpha_2 SIZE_t + \alpha_3 ACCRUALS_t + \alpha_4 ROA_t + MB_t + \epsilon_t$$

$$1b: UE_ \Delta CE_{t+1} = \eta_0 + \eta_1 SI_t + \eta_2 SIZE_t + \eta_3 ACCRUALS_t + \eta_4 ROA_t + MB_t + v_{t+1}$$

$$1c: UE_CE_t = \alpha_0 + \alpha_1 OCI_t + \alpha_2 SIZE_t + \alpha_3 ACCRUALS_t + \alpha_4 ROA_t + MB_t + \epsilon_t$$

$$1d: UE_ \Delta CE_{t+1} = \eta_0 + \eta_1 OCI_t + \eta_2 SIZE_t + \eta_3 ACCRUALS_t + \eta_4 ROA_t + MB_t + v_{t+1}$$

Variable Definition:

- UE_CE = unexpected core earnings
- $UE_ \Delta CE$ = unexpected change in core earnings
- SI = special items
- OCI = other comprehensive income

SIZE = company size
 ACCRUALS = operating accruals
 ROA = return on assets
 MBt = market to book ratio

*If coefficient $\alpha_1 > 0$ and $\eta_1 < 0$, shifting/real earnings management is indicated.

Different tests were done to determine companies conducting more earnings management by comparing reports using OCI and those using SI. In Hypothesis 2 (H2), different testing was also performed to compare differences between countries with a low level of uncertainty avoidance and those with a high level of uncertainty avoidance, where more earning management was carried out using classification shifting.

IV. HYPOTHESES TESTING AND FINDINGS

This research aims to obtain empirical evidence of earnings management behavior through classification shifting in the capital market using two prevailing standards in different countries.

A. Hypotheses Testing

This research compared local GAAP standards that use special items (SI) and new IFRS used in other comprehensive income (OCI). The first and second research hypotheses (H1 and H2) suggest that listed companies perform earnings management by either transferring core operating costs to non-operating costs (transitory) or performing classification shifting under the following two conditions:

Unexpected core earnings (UE_CE_t) in year t is expected to increase with the existence of special posts (SI) in year t , while unexpected change in core earnings (UE_ACE_{t+1}) in year $t+1$ is expected to decline (decreasing) in the presence of special items (SI) in year t .

Based on those conditions, H1 regression equation was estimated as follows:

$$UE_CE_t = \alpha_0 + \alpha_1 \%SI + error_t$$

$$UE_ACE_{t+1} = \eta_0 + \eta_1 \%SI + V_{t+1}$$

Earnings management through classification shifting is supported if α_1 is positive and η_1 is negative.

Before testing the research hypotheses, the dependent variable to be used in regression equation testing has to be calculated,

$$UE_CE_t = reportedCE_t + predicted CE_t$$

$$UE_ACE_{t+1} = reported\Delta CE_{t+1} + predicted \Delta CE_{t+1}$$

To obtain the variables' coefficient, the models CE_t , ΔCE_t , ΔCE_{t-1} above were used to calculate the expected core earnings variable (UE_CE_t) which produces the coefficient α and (UE_ACE_{t+1}) indicates the coefficient η on the entire observation sample.

The first stage was to calculate unexpected core earnings (UE_CE_t) using Equation 1. If the test results of Equation 1 are supported, the testing phase is followed by calculation of unexpected change in core earnings (UE_ACE_{t+1}) to test Equation 2. Unexpected core earnings (UE_CE_t) values are expected to produce a positive coefficient α_1 in order that

Equation 2 to measure the unexpected change in core earnings (UE_ACE_{t-1}) can be proceeded with the expectation that a negative coefficient η_1 is generated, meaning that classification shifting occurs.

The research hypotheses were tested using linear regression equations as a method to test the occurrence of shifting on the transitory account in financial reporting. This test compared the standards applied by local GAAP (special items/SI) and those applied by IFRS (other comprehensive income/OCI).

Hypothesis 1 examined shifting in special items and other comprehensive income. Results show that special items generated a coefficient α of -945.56 ($\alpha < 0$) and a positive n -value of 7,156.81 ($\eta > 0$), indicating the absence of shifting. Hypothesis 1 also shows that the coefficient of other comprehensive income amounts to 4,656.47 ($\alpha > 0$) and the coefficient η amounts to -948.66 ($\eta < 0$), which imply that OCI experienced significant shifting or, on the other words, Hypothesis 1 is rejected.

Testing results reveal that Hypothesis 1 is rejected, which implies that there is a large gap between local standards that use rule-based GAAP and IFRS standards that are principle-based. Such a difference emerges because rule-based standards require more detailed reporting, but they require judgment from managers only, while the principle-based judgment indicates that many managers modify financial statements.

Hypothesis 2 tested the difference in classification shifting between countries with a low level of uncertainty avoidance and those with a high level of uncertainty avoidance. The testing results show that in countries with a low level of uncertainty avoidance, most managers opt not to perform classification shifting. It generated values of the coefficient α of special items and other comprehensive income by -4,109.08 and -17,575.8, respectively, and values of the coefficient η of special items and other comprehensive income by 49,077.56 and -6,700.54, respectively, suggesting the absence of shifting classification.

Testing results of Hypothesis 2 in countries with a high level of uncertainty avoidance prove classification shifting on the account of other comprehensive income as indicated by the values of its coefficient α by 4,976.97 ($\alpha > 0$) and coefficient η by -955.14 ($\eta < 0$). As for the account of special items, the coefficient α ($\alpha < 0$) amounts to 7,966.415 and the coefficient η amounts to 1,3467.39 ($\eta > 0$), meaning that no shifting occurs. These results confirm that Hypothesis 2 is accepted.

B. Research Findings

This research confirms that managers have a chance to perform earnings management through shifting classification. Investors should not ignore transitory accounts. Standards adopted by a country affect managers' decision to undertake earnings management. In the rule-based normal conditions, managers tend to obey regulations, thus there is no shifting classification. Conversely, in the principal-based normal conditions, an opportunity exists for managers to make modifications to financial statements, thus opening up the possibility of shifting.

In a country with a low level of uncertainty avoidance, both companies that use local GAAP standards and those adopting IFRS are not reported to have classification shifting indications. In this country, managers do not want to use the opportunity to modify financial statements. This is presumably due to the factor of cultural conservatism that exists among people in this country. Therefore, they tend to hold bad news, resulting in a low level of uncertainty avoidance. In addition, strict rules on local GAAP standards (special items) have an impact on the inability of managers to perform shifting.

In countries with a high level of uncertainty avoidance using rule-based standards, no classification shifting on special items was found. This is because these countries apply regulations which managers have to obey, making them unable to perform shifting. On the contrary, shifting on comprehensive income was detected in countries with a high level of uncertainty avoidance implementing IFRS. This may be caused by cultural characteristics of a modern society that does not want to keep bad news too long, thus placing extraordinary account immediately in the statement of comprehensive income.

C. Conclusions, Limitations, and Suggestions

This research provides evidence that local GAAP standards (special items) differ from IFRS (other comprehensive income) in terms of the classification of financial statements in transitory accounts. From six sample countries, no standard classification shifting was found when local GAAP were used in the statements of special items, but when IFRS standards were implemented shifting classification was found in the account of other comprehensive income.

Findings of this research show that classification shifting occurs in countries with a high level of uncertainty avoidance. This indicates that managers in these countries use the opportunity to modify financial statements. They immediately recognize losses in case of an event that is extraordinary and does not occur frequently. Conversely, managers in countries with a low level of uncertainty avoidance do not make the most of the opportunity to modify financial statements.

The different characteristics between rule-based standards and principle-based standards also result in differences in classification. The first generate more submissive and detailed financial statements, making it hard to do shifting, while the latter provide a greater opportunity for managers to justify that can lead to more shifting.

TABLE I. SHIFTING RESULTS

Variable	Sample	Coefficient		Description
		A	η	
SI	3003	-4,109.08	49,077.56	Shifting not happened
OCI	9326	-17,575.8	-6,700.54	Shifting not happened

*If $A > 0$ AND $\eta < 0$, SHIFTING IS DETECTED, WHERE A & η ARE CALCULATED FROM EQUATIONS

D. Limitations and Suggestions

This research has limitations in determining the year of observation. It compared five-year observation only because of a global crisis that occurred in 2008 and to avoid big bath between 2005 and 2007. Years of observation are also experiencing a lag in measurement models, thus decreasing the sample studied.

This research can serve as a reference for readers, academicians, and standard makers in determining which standard is more appropriate to consider in making managerial decisions. The transitory account should also be taken into consideration in addition to corporate earnings derived from the company's main operating results. Classification shifting is tested only in the case of transferred costs, without considering extraordinary income included in bottom earnings, so that test results could not be compared with each other.

One of the limitations of this research is that the researcher fails to collect information about the renewal of the contract performed by managers prior to the financial reporting period. This may cause erroneous measurement of variables under study. Another external factor is the institutional environment that has not been considered in this research, thus external influence can also change its results. Future research may take into account different institutional environments between countries.

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