UNIVERSITAS INDONESIA

FEB

CONFERENCE PROGRAM

Asian Academic Accounting Association 16th Annual Conference

BANDUNG, JAWA BARAT, INDONESIA. NOVEMBER, 15-17, 2015

With conference topics on :
ACCOUNTING, FRAUD,
CORRUPTION, AND
EARNINGS DECEPTION

Selamat Datang!

Welcome to the 16th Annual Conference of the Asian Academic Accounting Association (4A). We are delighted to be holding a 4A conference in Indonesia for the third time. Indonesia joins Malaysia as the only countries with the distinction of hosting the conference three times.

The 4A was launched in 1998 to serve as the professional organization for accounting academics in Asia and beyond. It brings together colleagues from many countries to share their research as well as to discuss pedagogical and other issues of mutual interest. Our mission is to facilitate collaborations and programs to enhance accounting education and research. We are an organization of our members and for our members. I urge you to participate in the current activities of the 4A as well as to suggest additional programs and activities that are of interest to you.

On behalf of the 4A Executive Committee and all 4A members, I thank our colleagues at the University of Indonesia for hosting this year's conference. I particularly thank Dr. Ancella A. Hermawan and her dedicated team of Organizing Committee members for their planning and dedication in putting together a superb conference. I also take this opportunity to thank our sponsors, our keynote speakers and our honored guests.

I hope that you will take advantage of the wonderful program that they have arranged and take the opportunity to renew acquaintances with old friends, to make new friends, and to grow your professional networks during the conference. I wish all participants a productive and enjoyable conference and visit to Indonesia.

Shahrokh M. Saudagaran

Secretary General, Asian Academic Accounting Association

Selamat Datang!

All praise and glory be to God for all His blessings upon us. We would like to thank the Asian Academic Accounting Association for letting us organize the event.

The 16th Asian Academic Accounting Association (AAAA) Annual Conference is held in Bandung, West Java, Indonesia hosted by Universitas Indonesia. This year Annual Conference addresses the latest issues in accounting covering wide research areas such as Corporate Social Responsibility and Corporate Governance, Financial Accounting and Reporting, International Accounting, Auditing and Internal Controls, Management Accounting, Taxation, Accounting Education, Corporate Finance and Capital Markets, Social and Environmental Accounting, Public Sector Accounting, Forensic Accounting, Islamic Accounting, Accounting Information Systems, and Case Studies and Issues in Accounting. The conference brings together a diverse group of accounting and finance educators and professionals from throughout Asia and the rest of the world.

The Committee received 136 paper submissions and 88 papers will be presented during the conference. We hope that this conference will bring positive and shared discussions to enhance the optimal outcome towards your research publications.

We hope that all of the participants could enrich their knowledge as well as enjoy the beauty atmosphere of Bandung during the conference.

Dr. Ancella A. Hermawan

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16th ANNUAL CONFERENCE ASIAN ACADEMIC ACCOUNTING ASSOCIATION

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16th ANNUAL CONFERENCE

ASIAN ACADEMIC ACCOUNTING ASSOCIATION

PROGRAM

SUNDAY, NOVEMBER 15, 2015

19.00 – 21.00 Welcome Dinner

MONDAY, NOVEMBER 16, 2015

08.00 – 09.00 Registration

09.00 – 09.15 UI Corporate Video Presentation

09.15 – 09.30 Welcoming Address by the President of Asian Academic Accounting Association (AAAA)

09.30 – 10.00 **Opening speech by Dr. Muliaman D. Hadad**, *Chairman of Board of Commissioners of the Indonesian Financial Services Authority* (Otoritas Jasa Keuangan/OJK)

10.00 – 10.30 **Keynote Speech by Prof. Dr. Normah Omar**, *Director of Accounting Research Institute, Universiti Teknologi MARA*

10.30 – 10.45 Coffee Break

10.45 – 12.15 **Panel Session 1**: **Fraud and Deception in the Financial Reporting**

Speakers:

- **Dr. Etty Retno Wulandari**, *Indonesian Financial Services Authority (Otoritas Jasa Keuangan / OJK)*
- **Mr. Sulistyo Wibowo**, *Directorate General of Taxation (DGT)*
- **Prof. Kamran Ahmed, PhD., FCPA**, *Professor of Accounting and Accounting Graduate Research Coordinator, La Trobe Business School, Australia*

Moderator: **Dr. Elvia Shauki**, *Universitas Indonesia/University of South Australia*

12.15 – 13.30 Lunch

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CONCURRENT SESSION 1- B

THE EFFECT OF ENVIRONMENTAL PROBLEMS AMD FINANCIAL PROBLEMS ON *EARNINGS MANAGEMENT*

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ABSTRACT

This study aims to examine the effect of environmental and financial problems faced by Indonesian listed firms on earnings management practices. The sample was taken from non-financial companies listed in IDX in 2011-2015. Environmental problems and financial problems were identified from the news media where the sample firms were reported to have related issues. Earnings management is calculated using accrual-based earnings management and real earnings management. Three control variables were included in the model: firm size, leverage and profitability. The sample was selected using purposive sampling method resulted in 220 observations consisting of 44 companies in five year periods. The model was run using multiple regression analysis. The result shows that environmental problems have a positive effect on accrual-based earnings management and therefore provides evidence that supports the political cost hypothesis. While financial problems have no significant effect on accrual-based earnings management. This study also finds that both environmental and financial problems have no association with real earnings management.

Keywords: earnings management, accrual-based earnings, real earnings management, political cost hypothesis, enviromental problems, financial problems.

I. INTRODUCTION

Financial statements are a means to account for what is done by management on the resources owned by the company's stakeholders. Stakeholders use financial statements to find out information about the financial condition of a company that is useful in making economic decisions. One of the important parameters in the financial statements used to measure company performance and used as a basis for decision making is earnings information (Widyaningdyah, 2001). Earnings information is one of the information contained in financial statements and is often the target of engineering through opportunistic management actions to maximize satisfaction, but on the other hand it can be detrimental to shareholders, creditors and investors (Nuryaman, 2009). This management behavior is known as earnings management.

Financial statements have basically been regulated by a standard in the preparation process, but it should be realized that financial statements contain many assumptions, judgments and managers have the flexibility to choose several alternatives in recording transactions as well as choose the options contained in accounting policies. This flexibility allows for earnings management by company management (Subramanyam, 1996).

The basis for understanding earnings management actions in this study is formulated using one of the Positive Accounting Theory (PAT) hypotheses proposed by Watts and Zimmerman (1986), namely the political cost hypothesis. The hypothesis states that large companies tend to use accounting policies in lowering company profits than small companies. Large companies have a stronger incentive to carry out earnings management than small companies because large companies tend to get tighter supervision from the government and the general public.

Problems that arise in the company such as financial and environmental problems tend to cause public pressure and ultimately cause political costs for the company. Political costs include all costs that must be borne by companies related to political actions such as antitrust, regulations, government subsidies, taxes, tariffs, labor demands, and so on (Watts and Zimmerman, 1978).

Political costs arise because of public pressure received by the company as a result of unethical behavior carried out by the company. For example, the case that occurred in PT Megasari Makmur with its HIT product, became public attention because it was considered to have committed crimes and public lies by producing consumer goods containing hazardous chemicals (Nafi, 2006). Another case was experienced by PT Freeport Indonesia which was marked by strikes that were often carried out by trade unions as a result of demands for unfair salaries and bonuses received (Janur, 2016).

Cases related to the alleged monopoly and environmental pollution did not escape the public's attention. For example, the case of PT Bank Rakyat Indonesia (BRI), where in 2014 the company had to pay a fine of Rp. 25 billion from the Business Competition Supervisory Commission (KPPU), because it was proven to have committed a monopoly on mortgage insurance (Gideon, 2014), as well as a case of alleged environmental pollution that has the potential to endanger public health in Buyat Bay, Minahasa, North Sulawesi, which brought the name PT Newmont Minahasa Raya in 2004 (Karel et al., 2004).

The environmental and financial problems faced by the company as in the cases above, require the company to incur a high enough cost to resolve the case. The costs incurred for the company as a result of public pressure are called political costs. Companies tend to manipulate profits by reducing the profits earned to reduce the political costs that must be borne by the company and are expected to minimize various demands that arise from the public. According to Khalil and Simon (2014) this is done by managers to reduce the possibility of exposure to political or government intrusion in their business affairs.

The main purpose of this study is to understand how the influence of environmental problems and financial problems faced by companies, which triggers the emergence of political costs on the possibility of earnings management practices carried out by companies.

II. THEORY BASIS AND HYPOTHESES DEVELOPMENT

Agency Theory

According to Jensen and Meckling (1976), the agency relationship is the relationship between agents (managers) and principals (shareholders). In the agency relationship there is a contract in which one or more people (principals) instruct another person (agent) to perform a service on behalf of the principal and authorize the agent to make the best decision for the principal.

The agency relationship can often have an impact on the emergence of problems because there are differences in interests between the principal and management. Earnings management, one of which arises as a result of these differences in interests. Differences in interests and also more information owned by management will result in financial statements are often prepared in accordance with objectives that can benefit the management.

Earnings Management

Copeland (1968) defines earnings management as, "some ability to increase or decrease reported net income at will" which means that earnings management includes management's efforts to maximize, or minimize profits, including income smoothing in accordance with management's wishes.

The application of accrual accounting based on established accounting standards provides flexibility by allowing managers to choose accounting policies in reporting earnings. This is intended so that managers can inform economic conditions according to reality. However, these opportunities actually become motivations for managers to manage earnings.

Accrual-Based Earnings Management

According to Sulistyanto (2008) in Iranto (2014), accrual earnings management is carried out by playing with the accrual components in the financial statements, because the accrual component can be played with numbers through the accounting method used in accordance with the wishes of the person who records and prepares financial statements.

Accrual-based earnings management is one form of accrual accounting weakness that creates opportunities for managers to implement earnings management strategies as indicated by the existence of discretionary accruals (Hastuti, 2011). In the application of accrual accounting, managers are allowed to choose accounting policies in reporting earnings. This flexibility is intended so that managers can inform economic conditions according to reality. However, the flexibility of accounting principles creates opportunities for managers to manage earnings. Many studies present substantial evidence that managers take advantage of accounting policies that conform to generally accepted accounting standards and principles to manipulate accrual earnings through accounting selection and estimation.

Real Earnings Management

Real earnings management is a management action that deviates from normal business practices, which is motivated by the desire of managers to mislead at least stakeholders into believing that the financial reporting objectives have been achieved in the company's normal operations, with the main objective of manipulating current period earnings (Roychowdhury, 2006) and made throughout the accounting period.

Real earnings management has a direct influence on current and future cash flows, and also on the amount of accounting accruals, making it difficult for investors to understand this. Real earnings management can reduce firm value because the act of increasing current year's profit has a negative effect on future cash flows. Roychowdhury (2006) in his research indicates that managers often perform three types of real earnings management, namely sales manipulation, reduced discretionary spending, and excessive production.

The Political Cost Hypothesis

The political cost hypothesis was introduced by Watt and Zimmerman in 1986 and introduces a political dimension to the choice of accounting policy. This hypothesis states that if the company faces greater political costs, management should choose accounting procedures that delay reported income from the current period to future periods. This hypothesis also states that large companies tend to use accounting policies in lowering company profits than small companies.

Hypothesis Development

Problems that arise related to the environment and finance encourage companies to practice earnings management with the aim of reducing the political costs that must be incurred by the company and at the same time as a step for the company to maintain the good name and value of the company in the eyes of the public. To reduce adverse political concerns and associated costs (eg wage increases claims, product boycotts, or environmental concerns), politically sensitive firms (generally large firms) will adopt accounting methods that lead to a decrease in reported earnings.

Byard et al. (2007) examined the earnings management practices of oil companies in the US in the period after Hurricane Katrina and Rita in 2005. The results support the political cost hypothesis, that in that period managers tend to lower profits to reduce high political costs. Then, research by AlNajjar and Belkaoui (2001) shows that companies with high levels of profitability have the motivation to minimize profits, and Susilawati (2010), finds evidence that companies with high levels of profitability have a tendency to reduce profits with the aim of minimizing political costs such as : regulatory demands and labor demands. Based on the description above, it can be obtained a hypothesis in accordance with the political cost hypothesis as follows:

H1: The company's involvement in environmental problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice accrual-based earnings management.

H2: The company's involvement in financial problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice accrual-based earnings management

H3: The company's involvement in environmental problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice real earnings management.

H4: The company's involvement in financial problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice real earnings management.

III. RESEARCH METHOD

Population and Research Sample

The population in this study are all non-financial sector companies in the sub-sector of agriculture, mining, and manufacturing industries listed on the Indonesia Stock Exchange during the period 2011-2015. Meanwhile, the sample used is non-financial sector companies in the sub-sector of agriculture, mining and manufacturing industries listed on the Indonesia Stock Exchange for the period 2011-2015 using purposive sampling method. The criteria for sampling are:

1. The company has been involved in environmental problems or financial problems (details of problems are described in the problem definition) during the period 2011-2015.

2. The company is consistently listed on the Indonesia Stock Exchange in a row during the period 2011–2015.

3. The company is consistently classified as a non-financial sector company in the sub-sector of agriculture, mining and manufacturing during the period 2011–2015.

4. The company has data related to research variables and is completely available

Operational Definition and Measurement of Variable Data

The independent variables in this study are environmental problems (EPROBLEM) and financial problems (FPROBLEM). Environmental problems that become the scope of this research relate to: (1) Environmental pollution actions as a result of errors in the company's operational activities; (2) Land disputes (3) Natural disasters include fire events. Meanwhile, the financial problems that are the scope of this research relate to: (1) Workers' demands for wages, salaries, bonuses, etc., (2) government regulations on the prohibition of unhealthy business practices, prohibitions on the production or distribution of a product, taxes, and regulations related to subsidies from the government (3) Increase in the price of raw materials and product prices.

The independent variable in this study was measured using a dummy variable, with the provision that it will be coded one (1), if the company is included in the category of companies involved in environmental problems, or involved in financial problems that trigger political costs for the company; and is coded zero (0) if it does not fall into that category.

The dependent variable in this study is earnings management which is proxied by accrual-based earnings management and real earnings management

Accrual-Based Earnings Management

This study uses *Modified Jones Model* (Dechow *et al.*, 1995), to calculate *discretionary accruals* using the following formulas:

$$\mathbf{TAC = NI_{it} - CFO_{it}} \quad \text{.......} \quad (1)$$

$$\mathbf{TAC_{it} / TA_{it-1} = \alpha 1(1/TA_{it-1}) + \alpha 2(\Delta REV_{it} / TA_{it}\text{-}1) + \alpha 3\ (PPE_{it} / TA_{it-1}) + \boldsymbol{e}} \quad \text{.......} \quad (2)$$

$$\mathbf{NDA_{it} = \alpha 1(1/TA_{it-1}) + \alpha 2((\Delta REV_{it} - \Delta REC_{it}) / TA_{it-1}) + \alpha 3\ (PPE_{it} / TA_{it-1})} \quad \text{.......} \quad (3)$$

$$\mathbf{DA_{it} = (TAC_{it} / TA_{it-1}) - NDA_{it}} \quad \text{.......} \quad (4)$$

Where:

TAC	= total accruals
NI_{it}	= *net income* of firm *i* at year *t*
CFO_{it}	= *cash flow from operation* of firm *i* at year *t*
NDA_{it}	= *non-discretionary accrual* firm *i* at year *t*
TAC_{it}	= total accruals of firm *i* at year *t*
TA_{it-1}	= total assets of firm *i* at year *t*
ΔREV_{it}	= changes in revenues of firm *i* at year *t*
ΔREC_{it}	= changes in receivables of firm *i* at year *t*
PPE_{it}	= *gross property, plant and equipment* of firm *i* at year *t*
DA_{it}	= discretionary accruals of firm *i* at year *t*
e	= error

Real Earnings Management

This study uses the approach used in Roychowdhury's (2006) research, and is calculated using three proxies, namely abnormal operating cash flows, abnormal discretionary costs, and those calculated using the following formula:

a. *Abnormal CFO*

$$\mathbf{CFO_t/TA_{t-1} = \alpha 0 + \alpha 1(1/TA_{t-1}) + \alpha 2(S_t/TA_{t-1}) + \alpha 3(\Delta S_t/TA_{t-1}) + \mathit{e}_t}$$

Where:

CFO_t = cash flow from operations at year t
TA_{t-1} = Total asset at year t-1
S_t = Sales at year t
ΔS_t = Changes in sales at year t
e_t = *Error*

Abnormal operating cash flow (ACFOt) is the difference between the actual operating cash flow and normal operating cash flow calculated using the estimated coefficients above.

b. ***Abnormal Discretionary Expenses***

$$\mathbf{DISX_t/TA_{t-1} = \alpha 0 + \alpha 1(1/TA_{t-1}) + \alpha 2(S_t/TA_{t-1}) + \varepsilon_t}$$

where:
$DISX_t$ = discretionary expenditures at year t
TA_{t-1} = Total asset at year t-1
S_t = Sales at year t
ε_t = *Error*

Abnormal discretionary load (ADISXt) is the difference between actual discretionary load and normal discretionary load calculated using the estimated coefficients above.*Abnormal Production Cost*

$$\mathbf{PROD_t /TA_{t-1}= \alpha 0 + \alpha 1(1/TA_{t-1}) + \alpha 2(S_t/TA_{t-1}) + \alpha 3(\Delta S_t/TA_{t-1}) + \alpha 4(\Delta S_t\text{-}1/TA_{t1}) + \varepsilon_t}$$

Where:
$PROD_t$ = production cost at year t
$PROD_t$ = COGSt + ΔINVt.

Abnormal production costs (APRODt) is the difference between actual production costs and normal production costs calculated using the estimated coefficients above. The comprehensive calculation of real earnings management is measured by adding up the three real earnings management approaches (Cohen et al. 2008): $\mathbf{REM_t = ACFO_t + ADISX_t + APROD_t}$. This study also adds three control variables, namely: firm size (SIZE), leverage (LEV) and profitability (ROA).

Data Analysis

Hypothesis testing is done by using multiple regression analysis with the following regression equation:$\boldsymbol{EM = \alpha + \beta 1EPROBLEM + \beta 2FPROBLEM + \beta 3SIZE + \beta 4LEV + \beta 5ROA + e}$

Keterangan:

EM	= *Earnings Management*
α	= Konstanta
β1,2,3,4,5	= Koefisien regresi masing-masing proksi variabel independen dan kontrol
EPROBLEM	= Keterlibatan perusahaan dalam masalah lingkungan yang memicu timbulnya *political Cost*
FPROBLEM	= Keterlibatan perusahaan dalam masalah keuangan yang memicu timbulnya *political Cost*
SIZE	= ukuran perusahaan
LEV	= *Leverage*
ROA	= Profitabilitas
e	= Error

IV. ANALYSIS AND DISCUSSION

Based on the data obtained, there are 44 companies that meet the criteria as research samples. The observation period in this study was 5 periods (2011-2015), so the total number of data in the study was 220. In this study, there were 15 observations, so the total sample was 205 observational data.

This research has fulfilled the classical assumption test, namely normality, multicollinearity, autocorrelation, and heteroscedasticity tests. Based on Table 1 below, the results of the coefficient of determination for accrual-based earnings management (AEM) show the adjusted R square value of 0.079 which means that 7.9% of the variation of accrual-based earnings management (AEM) can be explained by independent variables and control variables in this study, while the remaining 92.1% was explained by other variables that were not included in the equation model of this study. Furthermore, the results of the coefficient of determination for real earnings management (REM) show a negative adjusted R square value of -0.04 which means that according to the data used in this study, the dependent variable of real earnings management (REM) cannot be explained by the variable independent, and control variables in this study, or in other words, there is no relationship between the dependent variable and the independent and control variables used in this study.

Table 1. Determination Coefficient

Variabel Dependen	Adjusted R Square	Std. Error of the Estimate

- *Accrual-Based Earnings Management* (AEM)	0,079	0,2568
- *Real Earnings Management* (REM)	-0,04	0,0404

Based on the results of the F-statistical test for accrual-based earnings management (AEM) shows the calculated F value of 4.495 with a significance level of 0.001 below 0.05. Then, the calculated F value of 4.495 shows a value greater than the F table value of 2.26. This can be interpreted that the independent variables and control variables simultaneously or simultaneously affect the accrual-based earnings management (AEM) significantly. Furthermore, the results of the F-statistical test for the real earnings management (REM) variable show the calculated F value of 0.823 with a significance level of 0.535 above 0.05. Then, the calculated F value of 0.823 shows a smaller value than the F table value of 2.26. This can be interpreted that the independent variables and control variables together or simultaneously have no significant effect on real earnings management (REM).

Hypoteses Testing

Table 2. Regression Results (1)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0,002	0,336		-0,007	0,995
	EPROBLEM	0,269	0,062	0,299	4,319	0,000
	FPROBLEM	-0,010	0,040	-0,017	-0,257	0,797
	SIZE	-0,002	0,011	-0,013	-0,187	0,852
	LEV	-0,085	0,084	-0,079	-1,012	0,313
	ROA	-0,290	0,138	-0,164	-2,098	0,037

Table 3. Regression Result (2)

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1,289	0,192		6,721	0,000
	EPROBLEM	0,009	0,009	0,067	0,929	0,354
	FPROBLEM	-0,010	0,006	-0,111	-1,563	0,120
	SIZE	-0,014	0,053	-0,019	-0,261	0,795

LEV	0,003	0,006	0,036	0,469	0,639
ROA	0,047	0,053	0,066	0,878	0,381

Discussion of the First Hypothesis (H1)

The value of t_count 4.319 > t_table 1.971, and a significance of 0.000 <0.050, it can be concluded that there is a significant effect between the independent variable environmental problems (EPROBLEM) on accrual-based earnings management (AEM). Based on the results of this study, the company's involvement in environmental problems that can trigger the emergence of high political costs for companies will encourage companies to practice accrual-based earnings management. The results of this study support Byard et al. (2007) who found evidence that companies tend to lower profits to reduce high political costs when environmental problems occur, namely after Hurricane Katrina and Rita in 2005. Research by Hall and Stammerjohan (1997) also proves that companies that face lawsuits due to the damage caused (such as supertanker accidents resulting in environmental pollution etc.) engineered profit reduction with the aim of minimizing the fines they bear.

Discussion of the Second Hypothesis (H2)

The value of t_count -0.257 < t_table 1.971, and a significance of 0.797 > 0.05, it can be concluded that there is no significant effect between the financial independent variable (FPROBLEM) on accrual-based earnings management (AEM).

Based on the research that has been done, it can be concluded that the independent variable of financial problems (FPROBLEM) in this study, has no significant effect on accrual-based earnings management (AEM). Thus, this study cannot prove that the company's involvement in financial problems that can trigger high political costs for the company will encourage companies to practice accrual-based earnings management.

The results of this study are not consistent with the research of Hsiao et al. (2016); Han and Wang (1998); Cahan (1992) and Na'im and Hartono (1996) which show that companies involved in financial problems (price increases, labor demands, monopolistic practices) have a tendency to reduce profits by managing earnings accruals to minimize political costs.

Discussion of the Third Hypothesis (H3)

The t value is 0.929 < t_table 1.971, and the significance is 0.354 > 0.050, it can be concluded that there is no significant effect between the independent variable environmental issues (EPROBLEM) on real earnings management (REM). Based on the research that has been done, it can be concluded that the independent variable environmental problems (EPROBLEM) in this study, has no significant effect on real earnings management (REM). This study cannot prove that the company's involvement in environmental problems that can trigger high political costs for the company will encourage companies to practice real earnings management. This means that there are variables that play a more important role in influencing the practice of real earnings management.

Discussion of the Fourth Hypothesis (H4)

The value of t_count -1.563 < t_table 1.971, and a significance of 0.120 > 0.05, it can be concluded that there is no significant effect between the financial independent variable (FPROBLEM) on real earnings management (REM).

Based on the research that has been done, it is concluded that the independent variable of financial problems (FPROBLEM) in this study, has no significant effect on real earnings management (REM). This study cannot prove that the company's involvement in financial problems that can trigger high political costs for the company will encourage companies to practice real earnings management. This means that there are variables that play a more important role in influencing the practice of real earnings management.

Previous studies related to this study only examined the relationship between the political cost hypothesis and accrual-based earnings management. This is probably because companies tend to prefer to carry out accrual earnings management (lower earnings) when involved in environmental or financial problems, because it is considered simpler to do than real earnings management.

V. CONCLUSIONS

Based on the results of the study, the following conclusions can be drawn. First, the results of this study provides evidence to support the political cost hypothesis, that the companies with environmental problems are exposed to high political costs and give incentives for them to use the accrual-based earnings management in order to reduce political pressures. Second, this study did not find the evidence that the firms who are involved in both financial and environmental problems use accrual-based earnings management to mitigate the pressures derived from the problems. Third, this study finds that firm profitability ROA) negatively affect the practice of accrual-based earnings management, while size and leverage did not give significant effect.

Some limitations of this study are not avoidable. First, this problems faced by the company may have different levels of severity and therefore may have different levels of impact on the company. Simplifying the problems may have biased the results. Further study may consider more detailed classification of both environmental as well as financial problems. Second, the selection of the sample is limited into non-financial sectors. Further study may consider including all industry sectors and test whether industry sectors may also affect differently in the relationship between environmental and financial problem to earnings management. Finally, more independent variables may be included in the model for future research, such as sales growth, CSR disclosure, and tax motivation.

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THE EFFECT OF ENVIRONMENTAL PROBLEMS AMD FINANCIAL PROBLEMS ON *EARNINGS MANAGEMENT*

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ABSTRACT

This study aims to examine the effect of environmental and financial problems faced by Indonesian listed firms on earnings management practices. The sample was taken from non-financial companies listed in IDX in 2011-2015. Environmental problems and financial problems were identified from the news media where the sample firms were reported to have related issues. Earnings management is calculated using accrual-based earnings management and real earnings management. Three control variables were included in the model: firm size, leverage and profitability. The sample was selected using purposive sampling method resulted in 220 observations consisting of 44 companies in five year periods. The model was run using multiple regression analysis. The result shows that environmental problems have a positive effect on accrual-based earnings management and therefore provides evidence that supports the political cost hypothesis. While financial problems have no significant effect on accrual-based earnings management. This study also finds that both environmental and financial problems have no association with real earnings management.

Keywords: earnings management, accrual-based earnings, real earnings management, political cost hypothesis, enviromental problems, financial problems.

I. INTRODUCTION

Financial statements are a means to account for what is done by management on the resources owned by the company's stakeholders. Stakeholders use financial statements to find out information about the financial condition of a company that is useful in making economic decisions. One of the important parameters in the financial statements used to measure company performance and used as a basis for decision making is earnings information (Widyaningdyah, 2001). Earnings information is one of the information contained in financial statements and is often the target of engineering through opportunistic management actions to maximize satisfaction, but on the other hand it can be detrimental to shareholders, creditors and investors (Nuryaman, 2009). This management behavior is known as earnings management.

Financial statements have basically been regulated by a standard in the preparation process, but it should be realized that financial statements contain many assumptions, judgments and managers have the flexibility to choose several alternatives in recording transactions as well as choose the options contained in accounting policies. This flexibility allows for earnings management by company management (Subramanyam, 1996).

The basis for understanding earnings management actions in this study is formulated using one of the Positive Accounting Theory (PAT) hypotheses proposed by Watts and Zimmerman (1986), namely the political cost hypothesis. The hypothesis states that large companies tend to use accounting policies in lowering company profits than small companies. Large companies have a stronger incentive to carry out earnings management than small companies because large companies tend to get tighter supervision from the government and the general public.

Problems that arise in the company such as financial and environmental problems tend to cause public pressure and ultimately cause political costs for the company. Political costs include all costs that must be borne by companies related to political actions such as antitrust, regulations, government subsidies, taxes, tariffs, labor demands, and so on (Watts and Zimmerman, 1978).

Political costs arise because of public pressure received by the company as a result of unethical behavior carried out by the company. For example, the case that occurred in PT Megasari Makmur with its HIT product, became public attention because it was considered to have committed crimes and public lies by producing consumer goods containing hazardous chemicals (Nafi, 2006). Another case was experienced by PT Freeport Indonesia which was marked by strikes that were often carried out by trade unions as a result of demands for unfair salaries and bonuses received (Janur, 2016).

Cases related to the alleged monopoly and environmental pollution did not escape the public's attention. For example, the case of PT Bank Rakyat Indonesia (BRI), where in 2014 the company had to pay a fine of Rp. 25 billion from the Business Competition Supervisory Commission (KPPU), because it was proven to have committed a monopoly on mortgage insurance (Gideon, 2014), as well as a case of alleged environmental pollution that has the potential to endanger public health in Buyat Bay, Minahasa, North Sulawesi, which brought the name PT Newmont Minahasa Raya in 2004 (Karel et al., 2004).

The environmental and financial problems faced by the company as in the cases above, require the company to incur a high enough cost to resolve the case. The costs incurred for the company as a result of public pressure are called political costs. Companies tend to manipulate profits by reducing the profits earned to reduce the political costs that must be borne by the company and are expected to minimize various demands that arise from the public. According to Khalil and Simon (2014) this is done by managers to reduce the possibility of exposure to political or government intrusion in their business affairs.

The main purpose of this study is to understand how the influence of environmental problems and financial problems faced by companies, which triggers the emergence of political costs on the possibility of earnings management practices carried out by companies.

II. THEORY BASIS AND HYPOTHESES DEVELOPMENT

Agency Theory

According to Jensen and Meckling (1976), the agency relationship is the relationship between agents (managers) and principals (shareholders). In the agency relationship there is a contract in which one or more people (principals) instruct another person (agent) to perform a service on behalf of the principal and authorize the agent to make the best decision for the principal.

The agency relationship can often have an impact on the emergence of problems because there are differences in interests between the principal and management. Earnings management, one of which arises as a result of these differences in interests. Differences in interests and also more information owned by management will result in financial statements are often prepared in accordance with objectives that can benefit the management.

Earnings Management

Copeland (1968) defines earnings management as, "some ability to increase or decrease reported net income at will" which means that earnings management includes management's efforts to maximize, or minimize profits, including income smoothing in accordance with management's wishes.

The application of accrual accounting based on established accounting standards provides flexibility by allowing managers to choose accounting policies in reporting earnings. This is intended so that managers can inform economic conditions according to reality. However, these opportunities actually become motivations for managers to manage earnings.

Accrual-Based Earnings Management

According to Sulistyanto (2008) in Iranto (2014), accrual earnings management is carried out by playing with the accrual components in the financial statements, because the accrual component can be played with numbers through the accounting method used in accordance with the wishes of the person who records and prepares financial statements.

Accrual-based earnings management is one form of accrual accounting weakness that creates opportunities for managers to implement earnings management strategies as indicated by the existence of discretionary accruals (Hastuti, 2011). In the application of accrual accounting, managers are allowed to choose accounting policies in reporting earnings. This flexibility is intended so that managers can inform economic conditions according to reality. However, the flexibility of accounting principles creates opportunities for managers to manage earnings. Many studies present substantial evidence that managers take advantage of accounting policies that conform to generally accepted accounting standards and principles to manipulate accrual earnings through accounting selection and estimation.

Real Earnings Management

Real earnings management is a management action that deviates from normal business practices, which is motivated by the desire of managers to mislead at least stakeholders into believing that the financial reporting objectives have been achieved in the company's normal operations, with the main objective of manipulating current period earnings (Roychowdhury, 2006) and made throughout the accounting period.

Real earnings management has a direct influence on current and future cash flows, and also on the amount of accounting accruals, making it difficult for investors to understand this. Real earnings management can reduce firm value because the act of increasing current year's profit has a negative effect on future cash flows. Roychowdhury (2006) in his research indicates that managers often perform three types of real earnings management, namely sales manipulation, reduced discretionary spending, and excessive production.

The Political Cost Hypothesis

The political cost hypothesis was introduced by Watt and Zimmerman in 1986 and introduces a political dimension to the choice of accounting policy. This hypothesis states that if the company faces greater political costs, management should choose accounting procedures that delay reported income from the current period to future periods. This hypothesis also states that large companies tend to use accounting policies in lowering company profits than small companies.

Hypothesis Development

Problems that arise related to the environment and finance encourage companies to practice earnings management with the aim of reducing the political costs that must be incurred by the company and at the same time as a step for the company to maintain the good name and value of the company in the eyes of the public. To reduce adverse political concerns and associated costs (eg wage increases claims, product boycotts, or environmental concerns), politically sensitive firms (generally large firms) will adopt accounting methods that lead to a decrease in reported earnings.

Byard et al. (2007) examined the earnings management practices of oil companies in the US in the period after Hurricane Katrina and Rita in 2005. The results support the political cost hypothesis, that in that period managers tend to lower profits to reduce high political costs. Then, research by AlNajjar and Belkaoui (2001) shows that companies with high levels of profitability have the motivation to minimize profits, and Susilawati (2010), finds evidence that companies with high levels of profitability have a tendency to reduce profits with the aim of minimizing political costs such as : regulatory demands and labor demands. Based on the description above, it can be obtained a hypothesis in accordance with the political cost hypothesis as follows:

H1: The company's involvement in environmental problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice accrual-based earnings management.

H2: The company's involvement in financial problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice accrual-based earnings management

H3: The company's involvement in environmental problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice real earnings management.

H4: The company's involvement in financial problems that trigger the emergence of political costs has a positive effect on the company's tendency to practice real earnings management.

III. RESEARCH METHOD

Population and Research Sample

The population in this study are all non-financial sector companies in the sub-sector of agriculture, mining, and manufacturing industries listed on the Indonesia Stock Exchange during the period 2011-2015. Meanwhile, the sample used is non-financial sector companies in the sub-sector of agriculture, mining and manufacturing industries listed on the Indonesia Stock Exchange for the period 2011-2015 using purposive sampling method. The criteria for sampling are:

1. The company has been involved in environmental problems or financial problems (details of problems are described in the problem definition) during the period 2011-2015.

2. The company is consistently listed on the Indonesia Stock Exchange in a row during the period 2011–2015.

3. The company is consistently classified as a non-financial sector company in the sub-sector of agriculture, mining and manufacturing during the period 2011–2015.

4. The company has data related to research variables and is completely available

Operational Definition and Measurement of Variable Data

The independent variables in this study are environmental problems (EPROBLEM) and financial problems (FPROBLEM). Environmental problems that become the scope of this research relate to: (1) Environmental pollution actions as a result of errors in the company's operational activities; (2) Land disputes (3) Natural disasters include fire events. Meanwhile, the financial problems that are the scope of this research relate to: (1) Workers' demands for wages, salaries, bonuses, etc., (2) government regulations on the prohibition of unhealthy business practices, prohibitions on the production or distribution of a product, taxes, and regulations related to subsidies from the government (3) Increase in the price of raw materials and product prices.

The independent variable in this study was measured using a dummy variable, with the provision that it will be coded one (1), if the company is included in the category of companies involved in environmental problems, or involved in financial problems that trigger political costs for the company; and is coded zero (0) if it does not fall into that category.

The dependent variable in this study is earnings management which is proxied by accrual-based earnings management and real earnings management

Accrual-Based Earnings Management

This study uses *Modified Jones Model* (Dechow *et al.*, 1995), to calculate *discretionary accruals* using the following formulas:

$$\mathbf{TAC = NI_{it} - CFO_{it}} \quad \text{.......} \quad (1)$$

$$\mathbf{TAC_{it} / TA_{it-1} = \alpha 1(1/TA_{it-1}) + \alpha 2(\Delta REV_{it} / TA_{it}-1) + \alpha 3\,(PPE_{it} / TA_{it-1}) + \textit{e}} \quad \text{.......} \quad (2)$$

$$\mathbf{NDA_{it} = \alpha 1(1/TA_{it-1}) + \alpha 2((\Delta REV_{it} - \Delta REC_{it}) / TA_{it-1}) + \alpha 3\,(PPE_{it} / TA_{it-1})} \quad \text{.......} \quad (3)$$

$$\mathbf{DA_{it} = (TAC_{it} / TA_{it-1}) - NDA_{it}} \quad \text{.......} \quad (4)$$

Where:

TAC = total accruals
NI_{it} = *net income* of firm *i* at year *t*
CFO_{it} = *cash flow from operation* of firm *i* at year *t*
NDA_{it} = *non-discretionary accrual* firm *i* at year *t*
TAC_{it} = total accruals of firm *i* at year *t*
TA_{it-1} = total assets of firm *i* at year *t*
ΔREV_{it} = changes in revenues of firm *i* at year *t*
ΔREC_{it} = changes in receivables of firm *i* at year *t*
PPE_{it} = *gross property, plant and equipment* of firm *i* at year *t*
DA_{it} = discretionary accruals of firm *i* at year *t*
e = error

Real Earnings Management

This study uses the approach used in Roychowdhury's (2006) research, and is calculated using three proxies, namely abnormal operating cash flows, abnormal discretionary costs, and those calculated using the following formula:

a. *Abnormal CFO*

$$\mathbf{CFO_t/TA_{t-1} = \alpha 0 + \alpha 1(1/TA_{t-1}) + \alpha 2(S_t/TA_{t-1}) + \alpha 3(\Delta S_t/TA_{t-1}) + \mathit{e}_t}$$

Where:

CFO_t = cash flow from operations at year t
TA_{t-1} = Total asset at year t-1
S_t = Sales at year t
ΔS_t = Changes in sales at year t
e_t = *Error*

Abnormal operating cash flow (ACFOt) is the difference between the actual operating cash flow and normal operating cash flow calculated using the estimated coefficients above.

b. ***Abnormal Discretionary Expenses***

$$\mathbf{DISX_t/TA_{t-1} = \alpha 0 + \alpha 1(1/TA_{t-1}) + \alpha 2(S_t/TA_{t-1}) + \varepsilon_t}$$

where:
$DISX_t$ = discretionary expenditures at year t
TA_{t-1} = Total asset at year t-1
S_t = Sales at year t
ε_t = *Error*

Abnormal discretionary load (ADISXt) is the difference between actual discretionary load and normal discretionary load calculated using the estimated coefficients above.*Abnormal Production Cost*

$$\mathbf{PROD_t /TA_{t-1}= \alpha 0 + \alpha 1(1/TA_{t-1}) + \alpha 2(S_t/TA_{t-1}) + \alpha 3(\Delta S_t/TA_{t-1}) + \alpha 4(\Delta S_t\text{-}1/TA_{t1}) + \varepsilon_t}$$

Where:
$PROD_t$ = production cost at year t
$PROD_t$ = COGSt + ΔINVt.

Abnormal production costs (APRODt) is the difference between actual production costs and normal production costs calculated using the estimated coefficients above. The comprehensive calculation of real earnings management is measured by adding up the three real earnings management approaches (Cohen et al. 2008): $\mathbf{REM_t = ACFO_t + ADISX_t + APROD_t}$. This study also adds three control variables, namely: firm size (SIZE), leverage (LEV) and profitability (ROA).

Data Analysis

Hypothesis testing is done by using multiple regression analysis with the following regression equation:***EM = α + β1EPROBLEM+ β2FPROBLEM + β3SIZE + β4LEV + β5ROA + e***

Keterangan:

EM	= *Earnings Management*
α	= Konstanta
β1,2,3,4,5	= Koefisien regresi masing-masing proksi variabel independen dan kontrol
EPROBLEM	= Keterlibatan perusahaan dalam masalah lingkungan yang memicu timbulnya *political Cost*
FPROBLEM	= Keterlibatan perusahaan dalam masalah keuangan yang memicu timbulnya *political Cost*
SIZE	= ukuran perusahaan
LEV	= *Leverage*
ROA	= Profitabilitas
e	= Error

IV. ANALYSIS AND DISCUSSION

Based on the data obtained, there are 44 companies that meet the criteria as research samples. The observation period in this study was 5 periods (2011-2015), so the total number of data in the study was 220. In this study, there were 15 observations, so the total sample was 205 observational data.

This research has fulfilled the classical assumption test, namely normality, multicollinearity, autocorrelation, and heteroscedasticity tests. Based on Table 1 below, the results of the coefficient of determination for accrual-based earnings management (AEM) show the adjusted R square value of 0.079 which means that 7.9% of the variation of accrual-based earnings management (AEM) can be explained by independent variables and control variables in this study, while the remaining 92.1% was explained by other variables that were not included in the equation model of this study. Furthermore, the results of the coefficient of determination for real earnings management (REM) show a negative adjusted R square value of -0.04 which means that according to the data used in this study, the dependent variable of real earnings management (REM) cannot be explained by the variable independent, and control variables in this study, or in other words, there is no relationship between the dependent variable and the independent and control variables used in this study.

Table 1. Determination Coefficient

Variabel Dependen	Adjusted R Square	Std. Error of the Estimate

- *Accrual-Based Earnings Management* (AEM)	0,079	0,2568
- *Real Earnings Management* (REM)	-0,04	0,0404

Based on the results of the F-statistical test for accrual-based earnings management (AEM) shows the calculated F value of 4.495 with a significance level of 0.001 below 0.05. Then, the calculated F value of 4.495 shows a value greater than the F table value of 2.26. This can be interpreted that the independent variables and control variables simultaneously or simultaneously affect the accrual-based earnings management (AEM) significantly. Furthermore, the results of the F-statistical test for the real earnings management (REM) variable show the calculated F value of 0.823 with a significance level of 0.535 above 0.05. Then, the calculated F value of 0.823 shows a smaller value than the F table value of 2.26. This can be interpreted that the independent variables and control variables together or simultaneously have no significant effect on real earnings management (REM).

Hypoteses Testing

Table 2. Regression Results (1)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0,002	0,336		-0,007	0,995
	EPROBLEM	0,269	0,062	0,299	4,319	0,000
	FPROBLEM	-0,010	0,040	-0,017	-0,257	0,797
	SIZE	-0,002	0,011	-0,013	-0,187	0,852
	LEV	-0,085	0,084	-0,079	-1,012	0,313
	ROA	-0,290	0,138	-0,164	-2,098	0,037

Table 3. Regression Result (2)

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1,289	0,192		6,721	0,000
	EPROBLEM	0,009	0,009	0,067	0,929	0,354
	FPROBLEM	-0,010	0,006	-0,111	-1,563	0,120
	SIZE	-0,014	0,053	-0,019	-0,261	0,795

LEV	0,003	0,006	0,036	0,469	0,639
ROA	0,047	0,053	0,066	0,878	0,381

Discussion of the First Hypothesis (H1)

The value of t_count 4.319 > t_table 1.971, and a significance of 0.000 <0.050, it can be concluded that there is a significant effect between the independent variable environmental problems (EPROBLEM) on accrual-based earnings management (AEM). Based on the results of this study, the company's involvement in environmental problems that can trigger the emergence of high political costs for companies will encourage companies to practice accrual-based earnings management. The results of this study support Byard et al. (2007) who found evidence that companies tend to lower profits to reduce high political costs when environmental problems occur, namely after Hurricane Katrina and Rita in 2005. Research by Hall and Stammerjohan (1997) also proves that companies that face lawsuits due to the damage caused (such as supertanker accidents resulting in environmental pollution etc.) engineered profit reduction with the aim of minimizing the fines they bear.

Discussion of the Second Hypothesis (H2)

The value of t_count -0.257 < t_table 1.971, and a significance of 0.797 > 0.05, it can be concluded that there is no significant effect between the financial independent variable (FPROBLEM) on accrual-based earnings management (AEM).

Based on the research that has been done, it can be concluded that the independent variable of financial problems (FPROBLEM) in this study, has no significant effect on accrual-based earnings management (AEM). Thus, this study cannot prove that the company's involvement in financial problems that can trigger high political costs for the company will encourage companies to practice accrual-based earnings management.

The results of this study are not consistent with the research of Hsiao et al. (2016); Han and Wang (1998); Cahan (1992) and Na'im and Hartono (1996) which show that companies involved in financial problems (price increases, labor demands, monopolistic practices) have a tendency to reduce profits by managing earnings accruals to minimize political costs.

Discussion of the Third Hypothesis (H3)

The t value is 0.929 < t_table 1.971, and the significance is 0.354 > 0.050, it can be concluded that there is no significant effect between the independent variable environmental issues (EPROBLEM) on real earnings management (REM). Based on the research that has been done, it can be concluded that the independent variable environmental problems (EPROBLEM) in this study, has no significant effect on real earnings management (REM). This study cannot prove that the company's involvement in environmental problems that can trigger high political costs for the company will encourage companies to practice real earnings management. This means that there are variables that play a more important role in influencing the practice of real earnings management.

Discussion of the Fourth Hypothesis (H4)

The value of t_count -1.563 < t_table 1.971, and a significance of 0.120 > 0.05, it can be concluded that there is no significant effect between the financial independent variable (FPROBLEM) on real earnings management (REM).

Based on the research that has been done, it is concluded that the independent variable of financial problems (FPROBLEM) in this study, has no significant effect on real earnings management (REM). This study cannot prove that the company's involvement in financial problems that can trigger high political costs for the company will encourage companies to practice real earnings management. This means that there are variables that play a more important role in influencing the practice of real earnings management.

Previous studies related to this study only examined the relationship between the political cost hypothesis and accrual-based earnings management. This is probably because companies tend to prefer to carry out accrual earnings management (lower earnings) when involved in environmental or financial problems, because it is considered simpler to do than real earnings management.

V. CONCLUSIONS

Based on the results of the study, the following conclusions can be drawn. First, the results of this study provides evidence to support the political cost hypothesis, that the companies with environmental problems are exposed to high political costs and give incentives for them to use the accrual-based earnings management in order to reduce political pressures. Second, this study did not find the evidence that the firms who are involved in both financial and environmental problems use accrual-based earnings management to mitigate the pressures derived from the problems. Third, this study finds that firm profitability ROA) negatively affect the practice of accrual-based earnings management, while size and leverage did not give significant effect.

Some limitations of this study are not avoidable. First, this problems faced by the company may have different levels of severity and therefore may have different levels of impact on the company. Simplifying the problems may have biased the results. Further study may consider more detailed classification of both environmental as well as financial problems. Second, the selection of the sample is limited into non-financial sectors. Further study may consider including all industry sectors and test whether industry sectors may also affect differently in the relationship between environmental and financial problem to earnings management. Finally, more independent variables may be included in the model for future research, such as sales growth, CSR disclosure, and tax motivation.

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