

QUANTITATIVE ANALYSIS
OF SOCIAL AND FINANCIAL
MARKET DEVELOPMENT

INTERNATIONAL SYMPOSIA IN ECONOMIC THEORY AND ECONOMETRICS

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INTERNATIONAL SYMPOSIA IN ECONOMIC THEORY
AND ECONOMETRICS VOLUME 30

QUANTITATIVE ANALYSIS OF SOCIAL AND FINANCIAL MARKET DEVELOPMENT

EDITED BY

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CHAPTER 1

EFFECT OF RELATED PARTY TRANSACTION AND POLITICAL CONNECTION ON REAL EARNINGS MANAGEMENT: STUDY ON MANUFACTURING COMPANIES LISTED IN INDONESIA STOCK EXCHANGE

Agustin Palupi and Lusiana Tania Aurelia

ABSTRACT

This study aims to examine the influence of related party transactions (RPTs), political connection (POLCON), board of directors (BOD), institutional ownership (IO), information asymmetry, audit quality (AQ), and leverage (LEV) on real earnings management (REM). The company used in this research is manufacturing companies listed on the Indonesian Stock Exchange from 2017 to 2019. The number of research samples is 192 firm years data. This study shows that RPTs, POLCON, IA, and LEV affect REM. In contrast, the BOD, IO, and AQ do not affect REM.

Keywords: Related party transaction; political connection; board of director; institutional ownership; information asymmetry; audit quality; leverage; real earnings management

1. INTRODUCTION

Management generally expects the company to get maximum profit. Profit is one of the benchmarks we use to see the company's performance. The greater the company's profit earned, the company's performance is considered better, and vice versa; if the level of profit generated is trimmed, the company's performance is considered less than optimal. Profit is crucial information, so company management often manipulates earnings to make them look better. Information about the company's profits can be seen in the financial statements.

One of the actions taken to manipulate profits is to practice earnings management. Earnings management can be defined as the company's management's efforts to intervene in financial reporting to deceive stakeholders who want to know how the company's performance and actual condition are. Earnings management can be done with two techniques: accrual-based earnings management and earnings management through real activities. According to Roychowdhury (2006), earnings management through real activities is a company management action that deviates from standard business practices with the primary goal of meeting specific revenue targets. Earnings management through real activities can be done with three approaches: operating cash flow, production costs, and discretionary costs. But with good corporate governance mechanism is expected to reduce opportunistic behavior of management and protect the interests of stakeholders (Alexander, 2021).

PT Indofarma carried out one case of earnings management through real activities in Indonesia. As reported by finance.detik.com (<https://finance.detik.com/bursa-dan-valas>, accessed March 7, 2020), through Bapepam's findings, this case began with an investigation conducted by Bapepam regarding alleged violations of laws and regulations in Indonesia. in the field of capital markets related to the presentation of financial statements by PT Indofarma. Bapepam found evidence that the value of Work in Process was exaggerated in the 2001 financial statements by Rp. 28.87 billion from the examination results. As a result, the Cost of Goods Sold is lower, and the same value overstates net income. This study was conducted to determine the effect of related party transactions (RPTs), political connections (POLCONs), board of directors (BOD), institutional ownership (IO), information asymmetry (IA), audit quality (AQ), and leverage (LEV) on real earnings management (REM) in manufacturing sector companies listed on the Indonesia Stock Exchange from 2017 to 2019.

2. THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

2.1. Agency Theory

According to Jensen and Meckling (1976), agency theory is the relationship between agents (management) and the principal (shareholders). An agency relationship is a work agreement (contract) in which one or more parties (principals) arrange for another party (agent) to perform work on behalf of the principal and delegate authority to the agent to make the best decisions for the principal. In agency theory,

it is explained about the relationship in the company between the principal (shareholder) and the agent (management). Agency theory that is starting to develop refers to fulfilling the primary goal of management to maximize value for shareholders. Three assumptions underlie agency theory, namely the human assumption, organizational assumption, and information assumption (Eisenhardt, 1989). In the human belief, human nature is generally selfish, has limited rationale regarding future perceptions (bounded rationality), and does not like risk (risk-averse). The organizational assumption states that there is a conflict of objectives among members, efficiency as a criterion of effectiveness, and the existence of IA between principals and agents in an organization. At the same time, the Information assumption states that information is a commodity with a cost and can be purchased. Agency theory states that many things in organizations are influenced by self-interest.

2.2. Real Earnings Management

According to Roychowdury (2006), earnings management through real activities is an action by company management that deviates from regular operating practices to convince stakeholders that specific financial reporting objectives have been met through regular activities. Earnings management through real activities can be done by manipulating sales, discretionary costs, and company production costs during the current period. Companies that earn near-zero profits will usually manage their real activity variables opportunistically, such as sales discounts, production levels, research and development, and other discretionary expenses to increase reported profits. Thus, earnings manipulated through certain real activities, such as price discounts and discretionary spending, maybe the optimal course of action under certain economic conditions. However, if managers are involved in this on a wider scale to meet revenue targets, then it is said that they carry out earnings management through real activities.

2.3. RPTs and REM

A RPT transfers resources, services, or obligations between the reporting entity and related parties, regardless of whether a price is charged (PSAK 7). According to Limanto and Herusetya (2017), transactions with related parties can be used as a tool for earnings management. RPTs could be used opportunistically to manipulate selling prices when doing upward selling or profit shifting. Amin, Niki, Suhardjanto, and Setiany (2018) stated that the higher concentration of ownership weakens the supervisory role audit committee on earnings quality.

The research results conducted by Abdullah, Hussin, and Nordin (2015) show that the higher the level of RPTs, the value of REM will also be higher. However, the research conducted by El-Helaly et al. (2018) shows that the higher the RPTs, the management will tend to avoid doing earnings management through real activities. Meanwhile, the results of research by Limanto and Herusetya (2017) show that RPTs do not affect REM. Therefore, based on the description above, the hypotheses that can be made are:

H_{a1} . RPTs affect REM.

2.4. POLCON and REM

Companies with POLCONs if members of the board of commissioners and BOD currently serving or have served or worked in the government include high-ranking military officers (Malik & Ahmad, 2017). The POLCON positively influences REM by manipulating cash flow operations, production costs, and discretionary expenditures. (Braam, Nandy, Weitzel, & Lodh, 2015; Chi, Liao, & Chen, 2016; Jia et al., 2019), Consequently, companies that carry out earnings management through real activities are more difficult to detect. Meanwhile, Fan (2017) and Malik and Ahmad (2017), it proves that POLCONs harm REM. Companies have POLCONs, and it will be easier to enter the capital market. Many other benefits that cause pressure on management to obtain high profits are reduced, so management's motivation to take earnings management actions is reduced. However, if only tested against cash flow from operations, the results of research conducted by Malik and Ahmad (2017) show that POLCONs do not affect. If only one person in the company has POLCONs, it will not affect management's actions to take REM actions. Based on the description above, the hypotheses that can be made are:

H_{a_2} , POLCON affects REM.

2.5. BOD and REM

According to Arifin and Destriana (2016), the BOD consists of people who determine essential policies in the company. The BOD is in charge of creating and regulating corporate governance mechanisms and influence the discussion process to essential decision-making in the company. Therefore, good corporate governance will reduce the opportunity to carry out earnings management through real activities.

The number of the BOD has a positive effect on REM, meaning that the larger the size of the BOD, the higher the REM carried out by the company (Al-Haddad & dan Whittington, 2019; Kharasgah, Amran, & Ishak, 2019; Talbi, Omri, Guesmi, & Ftiti, 2015). This result contradicts the research conducted by Susanto and Pradipta (2016), Swai and Mbogela (2016), and Chouaibi, Harres, and Ben Brahim (2018). On the other hand, the BOD harms REM. The larger the size of the BOD in a company causes a decrease in REM because of the supervision carried out by the BOD on management. Therefore, based on the description above, the hypotheses that can be made are:

H_{a_3} , The BOD affects REM.

2.6. IO and REM

According to Wiranata and Nugrahanti (2013), IO is thought to provide a supervisory mechanism within the company. Institutional investors can carry out active supervision because institutional investors tend to invest in huge investments so that supervision will be carried out more actively. Furthermore, Jensen and Meckling (1976) stated that IO has an essential role in minimizing agency conflicts between principals and agents. Therefore, the existence of institutional

investors is considered capable of maximizing the supervision of management performance by monitoring the decisions taken by the management as the manager of the company.

The greater the number of IO, the greater the occurrence of earnings management through real activities (Arlita, Bone, & Iwan Kesuma, 2019; Kusumawati et al., 2015; Setiawati & Lieany, 2016). The expectation of increased company profits and high returns from investors encourages management to take earnings management actions.

Susanto and Pradipta (2016) stated that IO harms REM. Institutional investors tend to invest in very large investments so that supervision will be carried out more actively and become an obstacle for management if they want to do earnings management (Haddad & Whittington, 2019; Swai & Mbogela, 2016)

Another study conducted by Nurzam, Gustri, and Wulanputih (2017) and Budi and Putri (2018) states that IO does not affect REM. Investors are temporary investors who only expect a high rate of return so that the supervisory function is carried out ineffectively, resulting in no influence on the company's operational activities. Based on the description above, the hypotheses that can be made are:

H_{a_4} . IO affects REM.

2.7. IA and REM

IA is a situation where the company's management has access to company information that is not owned by outside parties, including investors, creditors, banks, or the government. IA occurs because the principal does not have sufficient information about the agent's performance (Suhendah & Imelda, 2012, p. 266 in Dewi & Chandra, 2016).

Higher IA will increase REM (Jasman & Amin, 2017; Mardiana, 2019; Wicaksono, 2015; Wiyadi, Trisnawati, Puspitasari, & Sasongko, 2016). IA is an imbalance of information owned by management and investors that can encourage management to take earnings management actions. On the other hand, IA harms REM by manipulating discretionary expenditures (Amin, 2017). the existence of good corporate governance and the company being audited by external parties will reduce the information gap between management and stakeholders. Thus, management will not take earnings management actions. Putri and Sujana (2018) state that IA does not affect REM. IA is not a factor that management considers when it takes earnings management actions through real activities. Therefore, based on the description above, the hypotheses that can be made are:

H_{a_5} . IA affects REM.

2.8. AQ and REM

According to Hadi and Handojo (2017), financial statements are prepared by companies and used as information to users of financial statements after the report is audited by a Public Accounting Firm determined by the company. Therefore, audited financial statements will increase the credibility of the report. Utami and

Handayani (2019) stated that the better the selection of external auditors, the more credible the information presented in the financial statements. The external auditors who are classified as good are the big four Public Accounting firms.

The research results by Nihlati and Meiranto (2014) show that AQ harms REM through manipulation of cash flow operations. Therefore, management will be careful in carrying out earnings management not to be detected by the auditor. Companies audited by the big four CPAs tend not to do earnings management. This research aligns with the study conducted by Boedhi and Ratnaningsih (2015) through manipulation of cash flow operations and Sanjaya (2016) through manipulation of production costs and discretionary expenditures.

Research conducted by Puspitasari and Nugrahanti (2016) and Nugrahanti and Puspitasari (2018) states that the better the AQ, the greater the REM through cash flow operation manipulation. Companies that use audit services from the big four CPAs allow management to carry out earnings management through real activities because they are more difficult to detect.

Other research conducted by Sanjaya (2016) and Utami and Handayani (2019) shows that AQ does not affect REM. By using REM, auditors cannot reduce real activity manipulation because it is more difficult to detect. Therefore, based on the description above, the hypotheses that can be made are:

H_{a_6} . AQ affects REM.

3. RESEARCH METHODS

Manufacturing companies registered in Indonesia are the object of research used in this study. The research period is from 2017 to 2019. The samples are as follows (Table 1):

Table 1. Sample Selection Table.

Information	Number of Companies	Amount of Data
Manufacturing companies listed on the Indonesian Stock Exchange from 2015 to 2019	135	405
Manufacturing companies that do not consistently publish financial statements as of December 31 from 2015 to 2019	3	9
Manufacturing companies that do not consistently use Rupiah from 2015 to 2019	25	75
Companies that do not have IO from 2017 to 2019	3	9
Manufacturing companies that do not have RPTs from 2017 to 2019	24	72
Manufacturing companies that carry out stock splits and stock reverses from 2017 to 2019	2	6
Manufacturing companies that do not have bid and ask prices on the last day of stock trading from 2017 to 2019	8	24
Companies that do not have complete data related to research	6	18
Company sample quantity	64	192

Source: Data collection results.

4. MEASUREMENT OF VARIABLES

4.1. Real Earnings Management

Earnings management through real activities is defined as actions that deviate from the company's standard operating practices to convince stakeholders that specific financial reporting objectives have been met through normal activities (Roychowdhury, 2006). REM in this study is measured using three approaches taken from the research of Talbi et al. (2015). The steps to calculate REM, according to Talbi et al. (2015), are as follows:

1. Sales manipulation:

$$\frac{CFO_t}{TA_{t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \alpha_1 \frac{SALES_t}{TA_{t-1}} + \alpha_2 \frac{\Delta SALES_t}{TA_{t-1}} + \varepsilon$$

Information:

CFO_t = company operating cash flow in period t

TA_{t-1} = Total assets of the company at period $t - 1$

$SALES_t$ = Company sales on period t

$\Delta SALES_t$ = Changes in company sales in period t

ε = Error.

2. Discretionary expenditures:

$$\frac{DISX_t}{TA_{t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \alpha_1 \frac{SALES_{t-1}}{TA_{t-1}} + \varepsilon$$

Information:

$DISX_t$ = Discretionary cost, which consists of advertising expense, R&D expenses, sales and general expenses in period t

TA_{t-1} = Total assets of the company at period $t - 1$

$SALES_{t-1}$ = Company sales on period $t - 1$

ε = Error.

3. Over production:

$$\frac{PROD_t}{TA_{t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \alpha_1 \frac{SALES_{t-1}}{TA_{t-1}} + \alpha_2 \frac{\Delta SALES_t}{TA_{t-1}} + \frac{\Delta SALES_{t-1}}{TA_{t-1}} + \varepsilon$$

Information:

$PROD_t$ = company production cost in period t

TA_{t-1} = Total assets of the company at period $t - 1$

$SALES_{t-1}$ = Company sales on period t

$\Delta SALES_t$ = Changes in company sales in period t

$\Delta SALES_{t-1}$ = Changes in company sales in period $t - 1$

ε = Error.

4. REM:

Calculation of REM measured using three proxy which has been described above. First, the residual value of cash flow from operation and discretionary expense is multiplied by (-1). So, the formula for calculating REM is as follows:

$$\text{REM} = -\text{SR}(\text{Ab_CFO}) + \text{SR}(\text{Ab_PROD}) - \text{SR}(\text{Ab_DISX})$$

Information:

BRAKE = REM

SR(Ab_CFO) = Standardized residual abnormal operating cash flow of the company

SR(Ab_PROD) = Standardized residual abnormal company production costs

SR(Ab_DISX) = Standardized residual abnormal company discretionary costs.

4.2. Related Party Transactions

An RPT transfers resources, services, or obligations between the reporting entity and associated parties, regardless of whether a price is charged (PSAK 7). This variable is measured by calculating RPTs divided by the company's total sales. The proxies for calculating RPTs are taken from the research of [Limanto and Herusetya \(2017\)](#):

$$\text{RPT} = \frac{\text{Total RPT}}{\text{Total Sales}_t}$$

Information:

RPTs = Related party transactions

Total RPT = Total RPT (acquisition of assets, assets sales to the related party, equity sales to the related party, trading relationships, and cash payment or loan to related party)

Total Sales = Total sales period t .

4.3. Political Connection

Companies that have POLCONs if the board of commissioners and BOD are currently serving or have served or worked in the government, including high-ranking military officers ([Malik & Ahmad, 2017](#)). This variable is measured using a dummy variable. A value of 1 is for companies with POLCONs, and 0 is for companies that do not have POLCONs ([Malik & Ahmad, 2017](#)).

4.4. Board of Directors

According to [KNKG \(2006\)](#), the BOD is a collegially responsible corporate organ responsible for managing the company. Each panel of directors can carry out its duties and make decisions by assigning responsibilities and authorities. This variable is measured by looking at the size of the BOD of a company.