



Does Earnings Management Practice Increase Stock Return?

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Abstract

This research aims to get empirical evidence of the effect of earnings management in increasing stock returns received by the investor. Earnings management is an activity of the manipulated financial statement. Earnings management can be used to improve company performance when the company has a lousy performance or can be used to maintain company performance. There are two earnings management, accrual and actual activity manipulation. This research used both to see which one can increase stock return. This research used multiple regression analysis to test the hypothesis, and the samples are manufacturing companies listed on Indonesia Stock Exchange from 2017-2019. 86 companies are selected as samples using purposive sampling. The results showed that earnings management is a negative signal for investors. When a negative signal is given to investors, it will cause a decrease in the stock return received by the investor. This research provides an overview of earnings management practices that can make investors suffer losses so that capital market supervisors can increase the monitoring of these manipulation practices.

Keywords: stock return; accrual earnings management; actual activity manipulation; accrual; signaling theory

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1. Introduction

Investors are one of the essential parties as a source of funding in the company. The more investors who invest in the company, the more funds will be obtained by the company to finance the company's operations. The higher the level of industry competition, each company competes in getting investors' attention so that investors are interested in investing in the company. One way to attract investors is to provide financial information that shows the company's performance. This financial information can be obtained from financial reports issued by the company every quarter or yearly. This financial information is the primary key to getting investors' attention, especially regarding the company's

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profit/loss. If the company makes a profit, this is good news for investors because the company can generate profits and will increase its value of the company.

On the other hand, if the company makes a loss, this is terrible news for investors. With this loss, the company's value will decrease, and investors will become reluctant to invest. One of the sectors that became investors interested in investing in Indonesia during 2019 was the manufacturing sector, which can be seen in the graph below.

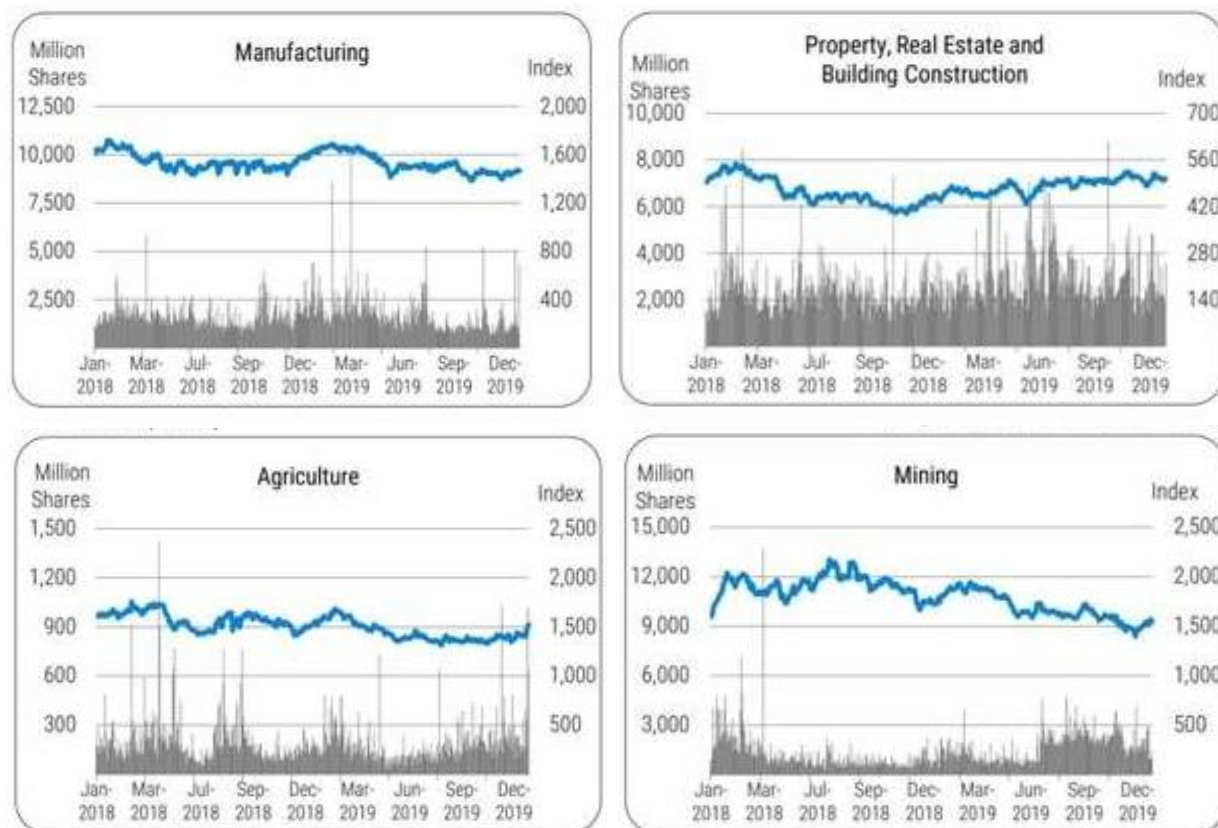


Figure 1. Graph of stock trade volume

The manufacturing sector has the largest share trading compared to others listed on the Indonesia Stock Exchange, so the transparency of the financial statements of manufacturing companies plays a vital role for investors. Investors entrust their funds to be managed by the management to increase the return received. Some companies report financial information transparently, and some companies do not report financial information transparently. This non-transparent information is caused by the company taking earnings management actions with the aim of providing good information in the midst of bad company conditions. PT Kimia Farma, PT Indofarma, and PT Hanson International are manufacturing companies that carry out earnings management.

Earnings management actions will increase the return investors receive because the company's performance looks excellent, so the company's stock price will increase. Earnings management only sometimes positively impacts the company, but the company can also accept the negative impact. Companies detected doing earnings management will provide negative sentiment for investors so that investor confidence in the company will decrease and cause the stock returns investors to decrease. Transparency in financial statements is essential for investors, and companies should be able to provide transparent information so that this company's actions harm no party.

This study aims to obtain empirical evidence regarding the effect of earnings management on stock returns. The different results of each study become the motivation to research earnings management and

stock returns. This study uses two earnings management approaches, accrual earnings management, and actual activity manipulation, to see the effect of each approach.

2. Literature Review

2.1. Signaling Theory

The signal theory states that the company will provide information that signals investors to make decisions. If the company provides positive information, this is a positive signal for shareholders, and vice versa. If the company provides negative information, then this will be a negative signal for shareholders. For example, company managers make changes in the company's accounting policies; this information can signal shareholders to make decisions to invest in the company (Hasanudin, 2018). The information released by the company is very influential on investment decisions. The information provided by the company include past (historical) information and future information related to the company's going concern. The more relevant and accurate the information provided by the company, the better the analysis carried out by investors for investment decisions (Adiwibowo, 2018).

Information provided by companies in financial statements that show exemplary performance this year and can provide good prospects for the years to come is considered a positive signal by investors. Changes in stock prices and stock trading volume will increase along with positive signals given by the company, affecting the increase in stock returns received by investors. On the other hand, if the information provided by the company in its financial statements shows poor performance this year and does not reflect good prospects for the future, it will be considered a negative signal for investors. This will impact a decrease in the volume of stock trading and stock prices, affecting the decline in stock returns received by investors. This is undoubtedly a concern for management always to provide positive information for investors so that there is an increase in stock trading which will increase the value of the company and the price of the company's shares. The company's financial condition, financial statements, and other factors will significantly affect investors' interest in stock trading.

2.2. Stock Return

Return is the return on results (losses or gains) obtained through share investment. This return can give positive or negative results. A positive return indicates that the company's stock investment benefits investors, while a negative return indicates that investors get a loss from stock investment (Sari & Hermuningsih, 2020). Investors can use the return to compare the expected profits from stock investments with the actual profits received. If the profits expected by investors are met by the actual profits provided by the company, this makes investors more confident to invest their funds in the company. All investors desire returns that follow investor expectations (Martono, 2018).

Stock returns are divided into two, namely realized returns and expected returns. Realized returns are returns that have already occurred and are calculated based on historical data. Realized returns are essential in measuring company performance and as a basis for determining future returns and risks. The expected return is the expected return in the future and is still uncertain because price changes influence it. The total return is the overall return obtained by investors from both realized and expected returns (Jogiyanto, 2017).

2.3. Earnings Management and Stock Return

Earnings management is the act of managers who use internal information and their experience to change numbers in financial statements, especially earnings, for the manager's benefit, thereby reducing the quality of their earnings (Subramanyam, 2014). Earnings management is an action that can cause information asymmetry and can be detrimental to those who use financial statements in the investment

decision-making process. Earnings management is divided into two forms, namely opportunistic earnings management and efficient earnings management. Opportunistic earnings management is activities carried out to increase management's utility to deal with political costs, compensation contracts, and debt contracts. Efficient earnings management is earnings management that is carried out because stakeholders provide management flexibility in protecting themselves from unexpected events that occur due to actions that increase the profits of the parties involved in the company contract (Kusmayadi, 2018).

Earnings management can be measured using Discretionary Accrual, which focuses on management actions in choosing accounting policies that will affect reported earnings in the company's financial statements (Fitrianiingsih, 2018). Accrual earnings management is carried out due to the authority delegated entirely to management related to the selection of accounting policies. Accruals in accrual earnings management are related to the recording and preparing of financial statements.

Besides using discretionary accruals, earnings management can be seen from actual activities. Fundamental activity manipulation is a form of earnings management carried out through the company's operational activities. This actual activity manipulation is measured by the existence of a practice that deviates from the company's normal operating activities so that it can be detected whether a company carries out earnings management or not (Adryanti, 2019). This actual activity manipulation focuses on activities related to operating cash flows, production costs, and discretionary costs. These three things can be used as a place for management to manipulate so that the profits generated by the company can increase or decrease.

Companies that carry out accrual and genuine earnings management can provide a positive signal to investors. This is because company reports provide information that shows good company performance so that the movement of stock returns received by investors will increase along with the increase in stock prices (Natural, 2021; Bansal et al., 2021). This encourages companies to manage earnings even though the information provided needs to be more transparent and tends to be misleading.

Earnings management can give a negative signal to investors. This is because the company provides information that is not transparent, so investor confidence in investing in the company will decrease. Investors will avoid investing in companies that carry out earnings management because the risk to be received is greater than the returns obtained, so this earnings management will reduce the returns received by investors (Bhutto et al., 2021; Istiqomah & Adhariani, 2017). Based on the explanation above, the hypotheses built are:

H1 Accrual Earnings Management affects Stock Return.

H2 Real Activity Manipulation affects Stock Return.

3. Method

The form of research used in this research is causality research. The research object used is a manufacturing company listed on the Indonesia Stock Exchange from 2017 to 2019. The sample selection method used in this study is the purposive sampling method. The hypothesis was tested using multiple regression analysis using SPSS. The sample companies obtained were 86 companies that met the predetermined criteria.

3.1. Stock Return

Gitman and Zutter (2015) define return as the total profit or loss obtained from an investment during a specific period. This is calculated by dividing the distribution of assets in cash during a period plus changes in value with the value of the investment at the beginning of the period.

$$\text{Return} = \frac{P_t - P_{t-1} + \text{Div}_t}{P_{t-1}} \quad (1)$$

Description:

P_t : Stock price at the date of issued financial statement year t

P_{t-1} : Stock price at the date of issued financial statement year t-1

Div_t : Dividend per share year t

3.2. Accrual Earnings Management

Earnings management can be measured using Discretionary Accrual, which focuses on management actions in choosing accounting policies that will affect reported earnings in the company's financial statements (Fitrianiingsih, 2018). The measurement scale is a ratio scale measured by the modified Jones model developed by Dechow et al. (1995) with the following steps:

$$TAit = Nit - CFOit \quad (2)$$

$$\frac{TAit}{Ait-1} = \beta_1 \frac{(1)}{Ait-1} + \beta_2 \frac{(\Delta Rev - \Delta Rec)}{Ait-1} + \beta_3 \frac{(PPEt)}{Ait-1} \quad (3)$$

$$DAit = \frac{TAit - ND Ait}{Ait-1} \quad (4)$$

Description:

$DAit$: Discretionary Accruals

$ND Ait$: Non-Discretionary Accruals

Nit : Net Income year t

$CFOit$: Cash Flow from Operation year t

$Ait-1$: Total Assets year t-1

ΔRev : Change in Revenue

ΔRec : Change in Receivables

PPE : Gross Property Plant Equipment

E : Error

3.3. Real Activity Manipulation

According to Simamora (2019), actual activity manipulation is manipulating profits through company operating activities motivated by management's desire to provide wrong information to investors. The measurement scale is a ratio scale that is measured using the model developed by Roychowdhury (2006) with the following details:

$$\frac{CFOt}{At-1} = \alpha_0 + \alpha_1 \frac{1}{At-1} + \beta_1 \frac{St}{At-1} + \beta_2 \frac{\Delta St}{At-1} + \epsilon t \quad (5)$$

$$\frac{PRODt}{At-1} = \alpha_0 + \alpha_1 \frac{1}{At-1} + \beta_1 \frac{St}{At-1} + \beta_2 \frac{\Delta St}{At-1} + \beta_3 \frac{\Delta St-1}{At-1} + \epsilon t \quad (6)$$

$$\frac{DISCt}{At-1} = \alpha_0 + \alpha_1 \frac{1}{At-1} + \beta_1 \frac{St}{At-1} + \epsilon t \quad (7)$$

Description:

CFO : Cash Flow from Operation

$At-1$: Total Assets year t-1

St	: Total Sales year t
ΔSt	: Change in Sales
$\Delta St-1$: Change in Sales year t-1
PROD	: Cost of Goods Sold plus Inventory
DISC	: Expense
e	: Error

From the regression results above, then all of them are added to get the value of actual activity manipulation. This study uses control variables, namely profitability which is measured using return on assets (ROA), sales growth (SG), and firm size (SIZE), which is measured using LN total assets.

4. Results

In the following, descriptive statistics for each variable and the results of hypothesis testing in this study are presented.

Table 1. Descriptive statistic

	RETURN	ACCRUAL	REM	ROA	SG	SIZE
Mean	-0.029818	0.056090	-0.008959	0.059573	0.109249	28.50862
Maximum	1.076923	0.400040	0.763630	0.920997	6.495556	33.49453
Minimum	-0.601770	0.000030	-0.859010	-0.401425	-0.841268	25.21557
Std. Dev.	0.231506	0.060752	0.249358	0.119003	0.512821	1.621074

Table 2. Hypothesis result

	Coefficient	t-statistic	Prob.	Coefficient	t-statistic	Prob.	Coefficient	t-statistic	Prob.
CONSTANTA	-0.2947			-0.4242			-0.3055		
ACCRUAL	-0.4504	-1.8258	0.0690*				-0.4574	-1.185	0.0647*
REM				-0.0729	-1.1162	0.0246	-0.0757	-1.211	0.2270
ROA	0.2499	2.0530	0.0411*	0.3042	2.2892	0.0229	0.3131	2.365	0.0187*
SG	0.0031	0.1088	0.9134	-0.0110	-0.3952	0.6930	0.0022	0.075	0.9388
SIZE	0.0096	1.0589	0.2906	0.0132	1.4745	0.1416	0.0098	1.086	0.2783

*significant on 10% dan 5%

5. Discussion

Based on the results of statistical tests, accrual earnings management harms stock returns. This can be seen in the probability value of 0.0690, which is smaller than the 10% alpha value. Companies that carry out earnings management will reduce the stock returns obtained by investors. Investors will avoid investing in companies that have high risk due to earnings management so that the returns obtained by investors will decrease. From the results of this study, it can also be seen that investors in Indonesia use analysis of financial statements more than directly trusting the information provided by the company (Istiqomah & Adhariani, 2017). The results of this study are supported by Bhutto et al. (2021), Istiqomah and Adhariani (2017), and Kusmayadi (2018), who conclude that earnings management has a negative effect on stock returns.

The results of hypothesis testing show that companies tend to use accrual earnings management more than actual activity manipulation. The absence of influence between actual activity manipulation and stock returns indicates this. Compared to manipulating the company's activities, companies are easier to manipulate through accruals, such as changing accounting policies or estimates. Profitability as a control variable has a positive effect on stock returns. Companies with high profitability are a positive signal

for investors, so the decision to invest in the company is getting more prominent along with the increase in the company's stock return.

6. Conclusions

This study aims to obtain empirical evidence regarding the effect of earnings management, both accruals, and actual activities, on stock returns. This study uses manufacturing companies as research samples and hypothesis testing using multiple regression analysis. The test results show a negative influence between earnings management, either accrual or natural earnings management, and stock returns. These results indicate that the company that does earnings management to make up its financial statement is a negative signal for investors, so the stock returns of companies that carry out earnings management will decrease. Earnings management usually done by companies are opportunistic earnings management. Earnings management can mislead investors, so investors avoid companies that carry out earnings management even though the reported earnings are significant, but this information needs to be more transparent. This study also provided that management will choose to do accrual earnings management than natural earnings management because accrual earnings management is easier to do by changing the accounting policy or estimation in accounting than by manipulating actual operating activities.

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Apakah Praktik Manajemen Laba Dapat Meningkatkan *Return* Saham?

Abstrak

Penelitian ini bertujuan untuk mendapatkan bukti empiris pengaruh manajemen laba dalam meningkatkan return saham yang diterima investor. Manajemen laba merupakan kegiatan untuk memanipulasi laporan keuangan. Manajemen laba dapat digunakan untuk meningkatkan kinerja perusahaan ketika perusahaan memiliki kinerja yang buruk atau dapat digunakan untuk mempertahankan kinerja perusahaan. Ada 2 manajemen laba, akrual dan manajemen laba riil. Penelitian ini menggunakan keduanya untuk melihat mana yang dapat meningkatkan return saham. Penelitian ini menggunakan analisis regresi berganda untuk menguji hipotesis dan sampelnya adalah perusahaan manufaktur yang terdaftar di Bursa Efek Indonesia periode 2017-2019. 86 perusahaan dipilih sebagai sampel dengan menggunakan *purposive sampling*. Hasil penelitian menunjukkan bahwa manajemen laba merupakan sinyal negatif bagi investor. Ketika sinyal negatif diberikan kepada investor, maka akan menyebabkan penurunan return saham yang diterima investor. Penelitian ini memberikan gambaran tentang praktik manajemen laba yang dapat merugikan investor, sehingga pengawas pasar modal dapat meningkatkan pengawasan terhadap praktik manipulasi ini.

Kata kunci: return saham, manajemen laba akrual, manipulasi aktivitas riil, teori sinyal

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