

**DOES INVESTOR PROTECTION PREVENT EARNINGS MANAGEMENT ACTIVITY
THROUGH REAL ACTIVITY MANIPULATION?**

ASIAN COMPARISON

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Abstract

This paper examines systematic differences in earnings management through real activity manipulation across 6 Asia countries. Contrary with Leuz (2003) finding that earnings management through accrual manipulation is lower in economies with high investor protection than in low investor protection. We predict that in economies with high investor protection, manager prefer to manage earnings through real activity manipulation rather than through accrual manipulation. Because accrual manipulation is more likely to draw auditor or regulator scrutiny than real decisions about pricing and production. Our findings are consistent with our prediction.

Keyword: earnings management, real activity manipulation, investor protection

INTRODUCTION

Legal systems protect investors by conferring on them rights to discipline insiders (e.g., to replace managers), as well as by enforcing contracts designed to limit insiders' private control benefits (e.g., La Porta et al., 1998; Nenova, 2000; Claessens et al., 2002; Dyck and Zingales, 2002).² As a result, legal systems that effectively protect outside investors reduce insiders' need to conceal their activities.

Investor protection as a key institutional factor affecting corporate policy choices (see Shleifer and Vishny, 1997; La Porta et al., 2000), we focus on investor protection as a significant determinant of earnings management activity. Leuz (2003) find: earnings management is more pervasive in countries where the legal protection of outside investors is weak, because in these countries insiders enjoy greater private control benefits and hence have stronger incentives to manipulate firm performance. Leuz measure earnings management with accrual manipulation, but beside manage earnings through accrual management, manager also can manage earnings through other method such as real activity manipulation and classification shifting. Accrual manipulation is more likely to draw auditor scrutiny than real decision. Thus, the purpose of this study is to investigate does investor protection reduce effectively earnings management through real activity manipulation.

Roychowdhury (2006) find evidence that manager in US firms manipulating earnings through real activity. US is characterized by large stock markets, low ownership concentration, extensive outsider rights, high disclosure, and strong legal enforcement. Roychowdhury find evidence suggesting price discounts to temporarily increase sales, overproduction to report lower cost of goods sold, and reduction of discretionary expenditures to

improve reported margins. This is contrary to Leuz finding that country with strong legal protection, manager less aggressive to manage earnings through accrual manipulation.

The manipulation of real activity potentially reduces firm value. Real activities manipulation can reduce firm value because actions taken in the current period to increase earnings can have a negative effect on cash flows in future periods. For example, aggressive price discounts to increase sales volumes and meet some short-term earnings target can lead customers to expect such discounts in future periods as well. This can imply lower margins on future sales. Overproduction generates excess inventories that have to be sold in subsequent periods and imposes greater inventory holding costs on the company. And based on Roychowdhury study, there is evidence that manager manipulating real activity in strong investor protection country.

According to surveys conducted by Bruns and Merchant (1990) and Graham et al. (2005), financial executives indicate a greater willingness to manipulate earnings through real activities rather than accruals. There are at least two possible reasons for this. First, accrual manipulation is more likely to draw auditor or regulator scrutiny than real decisions about pricing and production. Second, relying on accrual manipulation alone entails a risk. The realized year-end shortfall between unmanipulated earnings and the desired threshold can exceed the amount by which it is possible to manipulate accruals. If that happens, and reported income fall below the threshold, real activities cannot be manipulated at year-end. So, we argued that in country with high investor protection, manager don't have discretionary to manage earnings through accrual manipulation because accrual manipulation is more easily to detect, they will prefer to manage earnings through real activities.

This study focus on Asia countries to make contributing to the future of our society and Asia by expanding its range of the responsibilities through legal enforcement and investor protection in order to enhance economic development, mutual understanding and cooperation in Asia. The East Asian countries of Hong Kong, Malaysia, Singapore, Indonesia, Taiwan and Thailand provide a useful setting for testing the importance of investor protection. These countries have accounting standards that are generally viewed as high-quality, but (with the possible exception of Hong Kong) They have institutional structures that give preparers incentives to issue low-quality financial reports. Reporting quality of earnings ultimately is determined by the underlying economic and political factors influencing managers' and auditors' incentives, and not by accounting standards per se. Shareholder litigation is an important mechanism to enforce high quality financial reporting—particularly timely loss recognition—in common-law countries. The Asian countries experience comparatively little litigation. Saudagaran and Diga (2000) report that there have been no cases of judicial actions against auditors in Malaysia and Thailand. While there have been lawsuits against auditors in Singapore and Hong Kong, they are less frequent than in common-law countries (Choi et al., 1999).

While prior research has provided evidence on managers' incentives to manage earnings through accrual manipulation but there is relatively little evidence on incentive to manage earnings through real activity manipulation. Actually management have flexibility to manage earnings with accrual manipulation, real activities manipulation or classification shifting. Earnings management through accrual manipulation is more likely to draw auditor or regulator scrutiny than real decisions about pricing and production. So this paper attempts to provide evidence does investor protection prevent effectively from earnings management activity through other method beside accrual manipulation.

To measure earnings management through real activity manipulation we use Roychowdhury's model. We refine Roychowdhury's model by exclude suspect firm to predict normal level of cash flow, discretionary expenses, production cost. Suspect firm is firms which ratio net income to total asset in the interval greater than or equal to zero. We argue that suspect firm trying to avoid losses so they more aggressive in manage earnings to meet earnings threshold. Suspect firm close to zero earnings and they have incentive to manipulate real activity to avoid losses so they will reduce advertising expenses, R&D expenses or SG&A expenses, overproduction and suggesting price discount to increasing sales, So their CFO, discretionary expenses, Production cost is not in the normal level. Roychowdhury's model uses all sample (suspect and non suspect) to estimate normal level of cash flow, discretionary expenses and production cost.

We believe these study is useful to enhance our understanding about effectiveness of legal enforcement in protect outsider (minority) investor when manager have flexibility to choose earnings management method.

HYPOTHESIS

Earnings management can be defined as non-neutral financial reporting in which managers intervene intentionally in the financial reporting process to produce some private gain (Schipper 1989). Managers can intervene by modifying how they interpret financial accounting standards and accounting data, or by timing or structuring transactions (Healy and Wahlen 1999).

Prior accounting research has documented three main methods of earnings management. The most commonly studied method is accrual management (e.g., Healy 1985; Jones 1991; McNichols and Wilson 1988; Rangan 1998; Teoh et al. 1998; Phillips et al. 2003). Essentially, a manager can borrow earnings from future periods, through the acceleration of revenues or deceleration of expenses, in order to improve current earnings. In addition to the cost of detection, this method of earnings management bears a one-to-one cost of earnings reduction in the future; future-period earnings will be mechanically lower by the net income that was accelerated to current earnings. A second type of earnings management can occur through the manipulation of real activities, such as providing price discounts to increase sales and cutting discretionary expenditures, such as R&D, to manage earnings (e.g., Baber et al. 1991; Dechow and Sloan 1991; Bushee 1998). Such actions can increase revenues or net income, but they are also costly. For example, cutting R&D spending to manage earnings may result in the loss of future income related to the forgone R&D opportunities. On the other hand, because the manipulation of real activities is not a GAAP violation, this earnings management tool is expected to have a lower cost of detection than accrual management. Third potential earnings management tool is the misclassification of items *within* the income statement (classification shifting).

We focus real activities because in study comparison across countries, earnings management through classification shifting can be detected if these countries use the same standard because classification shifting need identification of special item in income statement. Real activities manipulation as departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain

financial reporting goals have been met in the normal course of operations. These departures do not necessarily contribute to firm value even though they enable managers to meet reporting goals. Certain real activities manipulation methods, such as price discounts and reduction of discretionary expenditures, are possibly optimal actions in certain economic circumstances. However, if managers engage in these activities more extensively than is normal given their economic circumstances, with the objective of meeting/beat an earnings target, they are engaging in real activities manipulation (Roychowdhury, 2006).

A number of studies discuss the possibility that managerial intervention in the reporting financial statement process can occur not only via accounting estimates and methods, but also through operational decisions. Manipulation by management through real activities is less likely to draw auditor or regulator scrutiny. In contrast accrual manipulation is more easily to detect. Leuz (2003) find that earnings management through accrual manipulation is less pervasive in countries where the legal protection of outside investors is strong, because in these countries legal system protect investor by conferring on them right to discipline insider.

There is evidence that manager in US firms manipulating earnings through real activity (Roychowdhury, 2006). US is characterized by large stock markets, low ownership concentration, extensive outsider rights, high disclosure, and strong legal enforcement. Leuz find that country with strong legal protection, manager less aggressive to manage earnings through accrual manipulation. So we argue that in strong legal enforcement economies, manager prefer to manage earnings through real activity manipulation rather than accrual manipulation because accrual manipulation is more likely to draw auditor or regulator scrutiny than real decisions about pricing and production. Accrual manipulation is more easily to detect, in other hand, real activities manipulation can be subjective, auditors might be limited in their ability to verify the appropriate classification.

In hypothesis 1 we argue that when legal enforcement strong, manager prefer to manage earnings through sales manipulation, reduce discretionary expenses and increasing production because real activity is less likely to draw auditor or regulator scrutiny than accrual manipulation.

To detect real activities manipulation we investigate patterns in CFO, discretionary expenses, and production costs following Roychowdhury (2006). Sales manipulation as managers' attempts to temporarily increase sales during the year by offering price discounts or more lenient credit terms. The cash inflow per sale, net of discounts, from these additional sales is lower as margins decline. The lower margins due to the price discounts cause production costs relative to sales to be abnormally high. These are essentially price discounts and lead to lower cash inflow over the life of the sales, as long as suppliers to the firm do not offer matching discounts on firm inputs. In general, sales management activities to lead to lower current-period CFO and higher production costs than what is normal given the sales level.

H1: Economies with high investor protection exhibit unusually cash flow from operation lower than in economies with weak investor protection.

To manage earnings upward, managers of manufacturing firms can produce more goods than necessary to meet expected demand. With higher production levels, fixed overhead costs are spread over a larger number of units, lowering fixed costs per unit. As long as the reduction in fixed costs per unit is not offset by any increase in marginal cost per unit, total cost per unit declines. This implies that reported COGS is lower, and the firm reports better operating margins. Nevertheless, the firm incurs production and holding costs on the over-produced items that are not recovered in the same period through sales. As a result, cash flows from operations are lower than normal given sales levels. Ceteris paribus, the incremental marginal costs incurred in producing the additional inventories result in higher annual production costs relative to sales.

H2: Economies with high investor protection exhibit unusually cost of good sold lower than in economies with weak investor protection.

H3: Economies with high investor protection exhibit unusually production cost higher than in economies with weak investor protection.

RESEARCH METHOD

We use all non financial firms in 6 Asia countries (Hongkong, Malaysia, Singapore, Indonesia, Taiwan and Thailand). Data are obtained from in Osiris Database between 2004-2007.

MEASUREMENT OF EARNINGS MANAGEMENT THROUGH REAL ACTIVITY MANIPULATION

Real activities manipulation is departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations (Roychowdhury, 2006) These departures do not necessarily contribute to firm value even though they enable managers to meet reporting goals. Certain real activities manipulation methods, such as price discounts and reduction of discretionary expenditures, are possibly optimal actions in certain economic circumstances. However, if managers engage in these activities more extensively than is normal given their economic circumstances, with the objective of meeting/beating an earnings target, they are engaging in real activities manipulation.

Following Roychowdhury (2006), normal cash flow from operations as a linear function of sales and change in sales in the current period. To estimate the model, We run the following cross-sectional regression for every industry and year:

$$CFO_t / A_t = \alpha_0 + \alpha_1 (1/A_{t-1}) + \alpha_2 (S_t / A_t) + \alpha_3 (\Delta S_t / A_t) + \epsilon_t$$

where A_t is the total assets at the end of period t , S_t the sales during period t and ΔS_t

= $St - St_{-1}$. For every firm-year, abnormal cash flow from operations is the actual

CFO minus the “normal” CFO calculated using estimated coefficients from the corresponding industry year model and the firm-year’s sales and lagged assets. Abnormal level = Actual level – Normal Level.

The model for normal COGS is estimated as

$$COGS_t / A_t = \alpha_0 + \alpha_1 (1/A_{t-1}) + \alpha_2 (S_t / A_t) + \alpha_3 (S_{t-1} / A_{t-1}) + \alpha_4 (S_{t-2} / A_{t-2}) + \varepsilon_t$$

Production costs as $PROD_t = COGS_t + INV_t$. Using (2) and (3), normal production costs from the following industry-year regression.

$$PROD_t / A_{t-1} = \alpha_0 + \alpha_1 (1/A_{t-1}) + \alpha_2 (\Delta S_t / A_{t-1}) + \alpha_3 (\Delta S_{t-1} / A_{t-1}) + \alpha_4 (\Delta S_{t-2} / A_{t-1}) + \varepsilon_t$$

Discretionary expenses be expressed as a linear function of contemporaneous sales,

similar to COGS.. The relevant regression would then be:

Differ from Roychowdhury study, we estimate these models using the non suspect sample only, not for entire sample. Suspect firm is firms in interval greater than or equal to zero. Because we argue that suspect firm trying to avoid losses so they more aggressive in manage earnings to meet earnings threshold. So their CFO, discretionary expenses, Production cost is not in the normal level.

MEASUREMENT OF INVESTOR PROTECTION

We use Leuz’s country cluster analysis, which groups countries with similar legal and institutional characteristics.

We use non parametric techniques to test differences abnormal CFO, COGS and Production Cost between cluster.

RESULT

To provide evidence on the systematic patterns in earnings management through real activity manipulation across groups of countries with similar institutional characteristics, we begin with a Leuz’s cluster analysis. The first cluster is characterized by large stock markets, low ownership concentration, extensive outsider rights, high disclosure, and strong legal enforcement. Hongkong, Singapore and Malaysia are in the first cluster. The second and third clusters show markedly smaller stock markets, higher ownership concentration, weaker investor protection, lower disclosure levels, and weaker enforcement. Taiwan is in the second cluster. Indonesia and Thailand are in the third cluster. Based on institutional characteristics, we refer to countries in the first cluster as “outsider economies.” The countries in the second and third clusters are referred to as “insider

economies,' with the distinction that countries in the second cluster have significantly better legal enforcement than countries in the third cluster.

Table 1 shows that differences between the clusters' average abnormal cash flow, abnormal cost of good sold and abnormal production cost are statistically significant. Outsider economies (cluster 1) exhibit higher levels of earnings management through real activity than insider economies (clusters 2 and 3).

**Table 1 Pervasiveness Earnings Management through Real Activity Manipulation
by Cluster**

	Abnormal Cash Flow	Abnormal Cost of good sold	Abnormal Production Cost
Cluster 1 (high investor protection)	2559,46	3643,70	3430,16
Cluster 2	2853,98	3705,25	3308,80
Cluster 3 (low investor protection)	4607,86	4358,72	3266,32
Sig	0.000	0.000	0.000

Mean abnormal cash flow in economies high investor protection (eq. Hongkong and Malaysia) is lower than in economies middle and weak investor protection (Taiwan, Indonesia, Thailand). The differences between cluster is statistically significant, thus H1 supported.

Mean abnormal cost of good sold in economies high investor protection (eq. Hongkong and Malaysia) is lower than in economies with middle and weak investor protection (Taiwan, Indonesia, Thailand). The differences between cluster is statistically significant, thus supported H2.

Mean abnormal production cost in economies high investor protection (eq. Hongkong and Malaysia) is higher than in economies with middle and weak investor protection (Taiwan, Indonesia, Thailand). The differences between cluster is statistically significant, thus supported H4.

CONCLUSION

This paper documents systematic differences in the level of earnings management through real activity

manipulation across 6 countries. We find evidence that real activity manipulation is varies systematically across these institutional clusters. The analysis suggests that in outsider economies with relatively dispersed ownership, strong investor protection, and large stock markets exhibit higher level of earnings management through real activity manipulation than insider countries with relatively concentrated ownership, weak investor protection, and less developed stock markets.

Contrary with Leuz (2003) that find earnings management through accrual manipulation is low in economies with high investor protection. The argument of our our finding is that accrual manipulation is more likely to draw auditor or regulator scrutiny than real decisions about pricing and production. So in economies with high investor protection, manager prefer to manage earnings through real activity manipulation. The findings highlight an important link between investor protection and the quality of accounting earnings reported to market participants. Our concern is how enhance the law enforcement to protect minority shareholders and outsider in the future?

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