The Discretionary Accrual in the Financial Statement of a Public Company in Indonesia: A Literature Review

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Abstract

Purpose – Previous studies distinguish revenue management based on discretionary accruals; the research of studies is to investigate the factors that affect the finance manager at the discretionary accrual in General financial information statement.

Design/Methodology/Approach – Literature review models used in research aimed at detecting any company that performs the company's discretion to fulfill the accrual of interests internally. This research study also discusses the relationship between earnings and discretionary manager behavior.

Findings – The researcher wants to re-examine the hypothesis of market efficiency on Indonesia's capital market. The current company information technology uses greatly influences worldwide investor interest to invest on Indonesian's capital market. Emerging Indonesia Capital market status becomes very interesting to be studied.

Originality/Value – It also presented the shortcomings of current research and the trends for future study in capital market.

Keywords Discretionary accrual, financial manager, investors, financial statement

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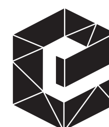
1. Introduction

The capital market is an activity related to the public offering and securities trading, the public company relating to the securities publishing, as well as the securities-related institutions and professions. Capital markets provide a wide range of investments to investors other than other investment alternatives such as saving in banks, buying gold, insurance, and land and buildings. In earnings, management research found the use of discretionary accruals to change the reported income between two fiscal periods. Earnings have two components: cash flow from operating activities and total accruals. Total accruals are assessments and management estimates of cash flows to make accounting profit reflect



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better economic performance, total accruals resulting from the amount of accrual discretion and non-discretionary accruals (Demirkan *et al.*, 2012).

To detect the presence of accrual discretion, we need a model specification to calculate the accrual discretion. The model ranges from simple, where total accrual is used as an accrual discretionary measure of a relatively sophisticated variable (regression), which describes accruals to discretion and non-discretionary components. Previous research has found evidence that accrual accounting has been performed in various forms. For example, research has found the existence of executive incentives to manipulate earnings in an attempt to meet the thresholds laid down in their bonus scheme contracts (Healy, 1985). Indicate that managers will manipulate earnings to reach such threshold as positive earnings, positive performance of previous period, and expectation analysis. The efficient contracting perspective of accounting choices provides evidence consistent with the idea that managers exercise accounting discretion to increase their compensation, avoid debt covenants violation, and reduce the chance of exposure to political or governmental intrusions into their business's affairs. Management may also tend to smooth the reported earnings in an attempt to meet investors' expectations of future cash flows.

In efficient marketing, theory is mentioned that stock prices are a reflection of all available information in the market (Bonazzi and Islam, 2007), and the result of competition among rational investors with a level of expectation free of sentiment and only related to factors fundamental in the analysis by investors. The results of the study conducted by Frugier *et al.* (2016) found that have a negative and insignificant effect on future profits, especially short-term stock returns during normal company situations, and a surprisingly significant positive effect during the crisis. The impact of sentiment is more pronounced on firms with more uncertain costs, and discovery of accrual discretion is associated with capital market incentives (Frugier *et al.*, 2016).

2. Research methods

2.1. Literature review about discretionary accrual

2.1.1. Executive bonus plans hypothesis Dechow *et al.* (2012) explained that the lower persistence of accruals can be grouped into two categories: the diminishing marginal returns embedded in new investment and accounting distortions. Baber and Fairfield (1991) showed the diminishing marginal returns imply that for high-profit companies, returns on the real investment acquired in the current period will be lower in the next period due to competition. This will drag down the average return for the company's real investments towards the long-term mean return. On the other hand, investments generating lower returns in the current period will be replaced by investments with better returns in the current or future period. This will drive up the average return towards the long-term mean.

Several studies documents evidence supporting the view of managers manipulates earnings when their potential compensation is linked with the value of shares and options. For example, Agnes Cheng and Reitenga (2009) demonstrate that the sensitivity of managers' wealth to the short-term stock price may motivate managers with high stock-based compensations and stock equity to manage earnings. More specifically, they emphasize that those managers are more likely to report earnings that meet or beat analysts' forecasts and sell more shares in the year after earnings announcement. Bergstresser and Philippon (2006) also found a significant association between equity incentives and abnormal accruals.

2.2. Debt covenants hypothesis

Francis *et al.* (2005) in relevant study provided evidence on the impact of accounting quail on the interest cost of debt in Barth *et al.* (2001) focus on the aggregate firm level interest cost of outstanding debt and find that interest costs for lowest accounting quality firms are higher 126 basis point relative to firms with the highest accounting quality. While their study provides an interesting first view on the role of accounting quality in debt markets, it leaves several unanswered questions. Unlike equity, debt contracts have multiple contract terms (interest, maturity, and collateral), and the role of accounting quality in the setting of multiple contract terms is not well understood. Lenders can fine tune the risk-return relationship with the borrower by setting terms for not only the interest cost but also the maturity term and collateral required in the contract.

Since debt agreements depend on accounting numbers reported on financial statements, managers have the opportunity to choose accounting methods that allow them to avoid violating these agreements. These contracts often include restrictive covenants that limit potential conflicts interest between firms' debt holders and shareholders, as well as restricting managers' scope to engage in activities that may adversely affect the debt holders' wealth. These include limiting the ability of management to issue new debt and giving the debt holders the right to demand early repayment of the debt when certain accounting numbers are not maintained (Kamarudin and Ismail, 2014).

2.3. Political costs hypothesis

Since large firms are usually more politically visible, abnormally large increases in reported earnings may be used as an indicator of a monopoly, or used as an excuse for political or governmental intrusions into their business's affairs (Khan and Watts, 2009). Thus, managers of large firms are expected to have greater incentives to make accounting choices that reduce the likelihood of these political costs being incurred. It found that firms use income-decreasing discretionary accruals in industries applying to the United States International Trade Commission for import relief, and in firms under investigation for anti-trust dealings during the year of the investigation. Similar results are found in the cable television industry and in chemical firms exposed to the Superfund laws (Khalil and Simon, 2014).

2.4. Earnings smoothing hypotheses

Earnings smoothing have been the subject of concern with regulatory and accounting studies alike. Managers may tend to use accounting discretion afforded by accounting standards to reduce the fluctuations of earnings in an attempt to report a less variable earnings stream and to show that the company has less risk. Managers can do so by, for example, understating earnings in years of high performance in order to create reserves for future periods. However, it is found that managers may engage in earnings smoothing even if managerial compensation is not tied with earnings (Khalil and Simon, 2014).

3. Relationship Between Discretionary Accrual And Opportunistic Manager

There are several references that explain the impact of discretionary accrual on opportunistic manager. It can be seen in Table 1.

3.1. The antecedents of discretionary accrual

Variable Discretionary Accrual not comes about easily but is formed from several sub-variables. Regarding above, no model can perfectly identify the benchmark level of accruals

expected as a response to the economics' conditions. Such a benchmark is needed to measure the discretionary component of accruals that is due to special incentives to manage earnings. There is much debate as to the success of the alternative proxies. For more details, see Table 2.

3.2. Suggestions for the Future Studies

Abnormal accruals have been the focus on much empirical research in accounting. Almost more than one hundred papers used "abnormal" accruals generated from an accruals' model as a measure of earnings quality. According to Dechow (1994), discretionary accruals often provide managers the opportunities to manipulate earnings due to the flexibility available. To detect earnings management, Healy (1985) was the first to introduce discretionary accruals. It was presumed discretionary accruals fall subject to managerial discretion while non-discretionary accruals of expected level of accruals in the firm provided there have no manipulation of earnings. Stock price-based incentives in the form of stock-based compensation and share ownership mitigate this disclosure agency problem. A positive relationship is found between discretionary accruals and the governance index. There is evidence of pervasive income smoothing, which improves the persistence and predictability of reported earnings.

For future research, the researcher must find the external aspect causing the accrual discretion to be done by the manager. Not only looking from the aspect of manager's interests in, but how the discretionary accruals in the financial statements are able to influence the users of financial statement information.

No.	Source	Relationship
1	Teoh *et al.* (2008)	Companies that conduct IPOs report higher earnings during the IPO by reporting aggressive abnormal accruals
2	Bernard and Skinner (1996)	Accrual accounting choices by managers are opportunistic and reflect other information
3	Khalil and Simon (2015)	Institutional ownership affects the accrual discretion
4	Huang *et al.* (2006)	Managers tend to behave opportunistically to maximize their interests at the expense of others
5	Dechow *et al.* (2012)	Characteristics of the company as an instrument of measurement of accrual quality, shows that the accrual quality is positively related to the persistence of the manager's earnings behavior
6	Mey and de Klerk (2015)	Accrual quality gets better when the CEO is a Chartered Accountant
7	Bergstresser and Philippon (2006)	The use of accrual discretion in reporting more severe earnings occurs in companies where the total of CEO's comparisons is more closely tied to share value and stock ownership options
8	Ashley *et al.* (2012)	The high earnings persistence increases the manager's chances of increasing salary and bonus compensation
9	Sweeney (1994)	Companies that have high debt levels tend to respond with changes in accounting revenues
10	Koerniadi and Tourani-Rad (2011)	Managers simultaneously use the accrual discretion and dividend changes in communicating company information about future profitability to the market
11	Alali (2011)	The influence of Cash Flow Operation mediation variation between the accrual discretion in financial report with audit fee

Table 1. Relationship between Discretionary Accrual and Opportunistic Manager

No.	Source	Compensation	Debt Covenant	Fee Audit	Antecedent Ownership Structure	Profitability	Return Stock	Sentiment Investor
1	Healy (1985)	✓						
2	Izadi Zadeh Darjezi (2016)	✓						
3	Khalil and Simon (2014)	✓ v	✓ v		✓ v	✓ v		
4	Herda *et al.* (2014)		✓ v					
5	Sweeney (1994)		✓ v					
6	Balsam (1998)	✓ v						
7	Gul *et al.* (2003)	✓ v		✓ v				
8	Koerniadi and Tourani-Rad (2011)					✓ v	✓ v	✓ v
9	Hribar *et al.* (2017)					✓ v	✓ v	✓ v
10	Mosebach and Simko (2010)	✓ v				✓ v	✓ v	
11	Linck *et al.* (2013)					✓ v	✓ v	
12	Khan and Mather (2013)	✓ v			✓ v	✓ v		
13	Hribar *et al.* (2007)					✓ v		✓ v
14	Demirkan *et al.* (2009)		✓ v			✓ v	✓ v	

Table 2. Antecedents of Discretionary Accrual

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