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24**HOW MANDATORY IFRS ADOPTION CHANGES FIRMS' OPPORTUNISTIC BEHAVIOR: EMPIRICAL EVIDENCES FROM THE EARNINGS MANAGEMENT PERSPECTIVE**

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20**ABSTRACT The purpose of this** research **is to examine the effects of International Financial Reporting Standards (IFRS)-** based accounting standards **on**

7**both accrual-based and real earnings management. We**

utilized modified Jones model

13**as a proxy for accrual based earnings management,** while abnormalities **found on**

13**cash flow from operations, discretionary expenses and production** expenses **are** used **as**

9**proxies for real earnings management. Using**

data from Indonesian manufacturing firms from 2009 to 2014, we found that adoption of IFRS limits discretionary behaviour in earnings management while the

9**earnings management** from **real activities is more**

prevalent

17**in the post IFRS period.** Keywords: IFRS, Real **Earnings Management,** Accrual **Earnings Management,**

Panel Data Analysis. INTRODUCTION Managerial opportunistic behaviour in the scope of financial reporting has become one of the main concerns for years. Agency theory has long argued that when the ownership and management are separated, the accounting and operational functions are affected by agency conflicts (Jensen and Meckling, 1976) and increase the information asymmetry between principal and managers. As a consequence,

11**managers may have** the **incentive to make decisions** to fulfil **their interest**

while to some extent, neglecting the interests of principal. Earnings management practice is one of those activities as a result of agency conflicts. Numerous researches have tried to uncover the reasons (and consequences) of the earnings management practice. However, we emphasized the roles of accounting standards that may inhibit (or foster) managerial opportunistic behaviour through earnings management. International Financial Reporting Standards was gradually implemented in Indonesia since 2012 in a hope to increase accounting and financial reporting quality. Researches however are stand divided about this. For example, more flexible accounting standard as in IFRS provides a greater scope for the discretion policy

11**and involve a higher degree of subjectivity** implied **in the application of criteria** (Jeanjean **and**

Stolowy, 2008). These “flexible” rules encourage managers to have a broader space in applying their policies that can be used for their own interests if there is no effective control mechanism. Callao and Jarne (2010) maintained that firms regulated by the “loose” accounting standards tend to engage more earnings management

4**(Callao and Jarne, 2010).** Additional evidences showed **that** the **principle-based accounting**

standards in IFRS provides more flexibility and hence looser as compared to the competing generally accepted accounting principles (GAAP) which is known to be “rules-based”. Capkun et al. (2012) also documented that earnings management increase can be observed among the companies in the countries that allow early IFRS adoption. However, Pelucio-Grecco et al. (2014) found that IFRS have restricted

6**effect on earnings management** in Brazil **after the** full **implementation of IFRS.**

Sellami and Fakhfakh (2014) on the other hand found that there is a

26**decrease in the** value **of the** absolute **discretionary accruals during the** six years **after the** mandatory adoption **of**

IFRS in France. Doukakis et al. (2014) shows

33**that mandatory IFRS** does **not significantly** affect **the** level of **accrual and real earnings management.**

Our research on the other hand, does not attempt to test whether there is a blessing (or curse) after IFRS implementation. Rather, we try to uncover the

5**earnings management practices on the accrual**

properties of accounting and manager's tendencies to manage their reported earnings through real operational activities; which are also one of our contributions in the financial accounting literature. Healy (1999) maintained that accrual-based earnings management are usually conducted by using extensive judgment in preparing the financial reporting and modifying financial transactions

37**to mislead** the **users of financial** statements **about the** firms' **real performance.** Roychowdury (2006) on **the**

other hand, define real earnings management as management desire to mislead the users of financial reporting by manipulating the operational activities that are supposed to in normal fashion. Our contributions also stem from the fact

1**that the impact of IFRS** to real **earnings management is**

categorized into their three main activities, namely:

10**abnormal production costs, abnormal** net **cash** flow **from operations and abnormal discretionary**

expenses. We also test whether IFRS may inhibit or foster those activities The

8**remainder of the paper** is organized **as follows. Section 2 provides a review of** relevant **literature and hypotheses** development. Section **3** describes **the sample selection,** variable measurement **and** research design. **Section** 4 **presents the** result. **Section**

5 provides summary conclusions, limitation of this study and future research potentials. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT Earlier researches have documented that IFRS may change how management behaves in managing their earnings. For example, Christensen et al. (2008) found that income smoothing is significantly lower among the firms that voluntarily adopt IFRS prior to its effective date. They further found that mandatory adopters perceive that the cost of early adoption outweighs its benefits. However,

21**Capkun et al. (2012)** noted **that earnings management increased**

can be observed among the firms that voluntarily adopt IFRS. Further studies have also documented the impacts of IFRS adoption (or convergence) on accounting quality.

4**Chen et al. (2010)** for instance, **found** a convincing **evidence of earnings management**

and absolute discretionary accruals and variations of unexplained accruals. Furthermore, they documented that IFRS encourages companies to engage in income smoothing practices.

6**On the other hand, Aussenegg et al. (2008)** using the **sample**

from 17 European countries found that earnings management decrease can be observed among the firms following IFRS adoption as opposed to countries-specific (i.e., domestic) standards. Firms also possess another alternative to manage their earnings through manipulating their real operational activities.

1**Graham et al. (2005)** conducted a **survey** indicating **that managers prefer real earnings management** instead of **accrual-based earnings management.** Empirical measures **of**

Roychowdhury (2006) also showed that the avoidance of losses reporting by the managers can be used through manipulation of their real activities management. A study conducted by

1**Zang (2012)** found **the trade-off** and substitution **between accrual-based and real earnings management. She**

also documented

5**a negative** correlation **between accrual and real earnings management.** IFRS Adoption and **Accrual Earnings Management**

As previously mentioned, IFRS provides inherent flexibility in applying the assets estimation through, for example, fair values method. This flexibility is provided through various alternatives in depreciation methods, inventory and revenue recognition, among others. Therefore, IFRS may provide broader room for the managers to achieve and set particular earnings that is not provided by prior, GAAP-based standards. Prior researches, to some extent also concur with the above lemma. For example, Jeanjean and Stolowy (2008) analysing the deviation of the income distribution as a proxy

6**of earnings management** examined **the** impact **of IFRS on** three **countries**

(i.e., Australia, United Kingdom and France). They found

1**that earnings management in** those **countries** are **not**

declining

4**and even** increasing **in France. Callao and Jarne (2010)** also showed **that** the **earnings management** increased **since the adoption of IFRS in**

11 countries in Europe. Using data in New Zealand from 2002-2009, Kabir et al. (2010) found that discretionary accruals are higher

21**after the adoption of IFRS** and shows **a** lower quality **of earnings**

at the time of IFRS implementation as compared to the pre IFRS. Therefore, we state our first hypothesis as follows: H1: Accrual earnings management practices are higher after IFRS convergence IFRS Adoption and Real Earnings Management Indeed, better accounting standards guarantee a better accounting quality, where they may increase the value relevance of financial reporting and earnings variability, among others. This will also yield that the firms' financial reporting can be easily scrutinized by the auditors and regulators. As a consequence,

28**firms may** opt **to engage in real earnings management** as **it is** more difficult **to**

detect when they try to manage their earnings rather than using accruals. Earlier researches have also noted that IFRS may increase the real management activities. One of the notable researches include Lippens (2008) that tested both real and accrual-based earnings management for the firms in EU countries following mandatory IFRS adoption. He

18**expected that the** rate **of accrual earnings management** will increase **in the** period after

6**mandatory adoption of IFRS and level of** real **earnings management** will decline during **the**

period. However, using the periods of 2000-2006 he showed that

18**level of accrual** and **real earnings management** increase significantly **in the**

period

1**after mandatory adoption of IFRS. In**

a survey

32**study, Graham et al. (2005)** found **that managers prefer** managing **earnings** through **real** activities **than**

through accrual policy. This is in line with Zang (2012) stating that the manager doing the manipulation of earnings through real activities first and then adjust the level of target profit by the use of discretionary accrual policies. Hence, the following hypothesis is proposed: H2: earnings management through real operational manipulation increases after firms adopt IFRS RESEARCH METHOD Sample

19**Selection The population in this study** includes all manufacturing **listed** firm in Indonesian **Stock Exchange**

from 2009-2014.The study

1**excludes observations with negative book value of equity** and **missing**

values. Data was taken from audited financial statement and annual report of the firm that publish at Indonesian Stock Exchange website (http://www.idx.com). As a result, we found a balanced sample set consist of 438 observation. Accrual Earnings Management Measure In this research, accrual earnings management is calculated using Modified Jones Models developed by

2**Dechow et al. (1995).** They showed **that Modified Jones Model is**

way better in earnings management detection rather than the original Jones model. They further also further added the change in account receivable in order to control for the possibility to use revenue as a source of earnings management. Modified Jones Models based on Dechow et al. (1995) are as follows: TAit/Assetsit

39-1=α0(1/ Assetsit -1)+α1(ΔSalesit/Assetsit -1)+α2(GPPEit/Assetsit -1)+εit (1)

1where TAit=total accruals, which is calculated as firm net income minus cash flows from operations;

Assetsit

38-1=total assets for firm; ΔSalesit =change in sales; GPPEit =gross property, plant and

equipment. Estimated parameters from

16(1) are then used to estimate the firm-specific nondiscretionary accruals

(NDAit): NDAit=α0(1/Assetsit-1)+α1(ΔSalesit/Assetsit-1–ΔARit/Assetsit-1)+α2(GPPEit/Assetsit-1) (2) Where NDAit=non-discretionary accruals;

1ΔARit=change in accounts receivable from year t- 1 to year t, while all other variables are as previously defined. We use discretionary accruals (DA) which is the difference between total accruals and the fitted nondiscretionary accruals

to measure accrual earnings management, which is defined as DAit=(TAit/Assetsit-1)–NDAit (3)

1Where DAit=discretionary accruals for firm i in year t. Real Earnings Management

Measure Roychowdury (2006) defined

1real earnings management as the difference

in operating practices with normal operating practice, motivated by the desire of management to mislead stakeholders so that they believe that the purpose of a particular

14financial reporting have been achieved in the normal operation practice of the company. Some areas that can be exploited in real activities manipulation include overproduction, sales management and reduction of discretionary expense. We use the following regression models for earnings management in three possible areas, including production (PROD), sales management (CFO) and discretionary expense reduction (DIEXP) is as follows:

3**PRODit/Ait-1=** α0 **+β1(1/Ait-1)+β2(Sit/Ait-1)+β3(ΔSit/Ait-1)+β4(ΔSit-1/Ait-1)+εit**

(4)

3**CFOit/Ait-1=** α0 **+β1(1/Ait-1)+β2(Sit/Ait-1)+β3(ΔSit/Ait-1)+εit**

(5) DISXit

3**/Ait-1=** α0 **+β1(1/Ait-1)+β2(Sit-** 1 **/Ait-1)+**

εit (6) where PRODit equals

36**to production costs, which is the** cost **of goods sold** plus inventories yearly **change;**

CFOit is firms' cash flows from operations; DISXit is discretionary expenses that is measured as

14**selling, general and administrative expenses** and Ait-1 **is** firms' **total assets; and** ΔSit=yearly **sales**

changes. As with prior researches, this study used the residuals found in equations (4), (5) and (6) to measure

1**abnormal production** cost **(ABN_PROD),** abnormal net **cash** flow **from operations** (ABC **_CFO) and** abnormal value of **discretionary expenses (ABN_**

DISEXP), respectively. In line with

7**Zang (2012) and Cohen and Zarowin (2010),** among others, **the** value **of**

1**ABN_CFO and ABN DISX** are multiplied **by** -1 **so** that **the higher** value indicates **the** higher

1**manipulation through price discounts and cutting discretionary expenses.**

To test the second hypothesis, we use the summated, composite score. We also run sensitivity tests, in which real earnings management proxies are separately regressed on IFRS. Panel Data Regression Panel data regression was used to test our hypotheses, since our study employs cross sectional firms and multiple years. Using panel regression analysis for these multidimensional types of data gives more efficient estimate (Baltagi 2005). Furthermore, with the panel data analysis, the unobserved heterogeneity both in time as well companies can also be controlled. The panel regression models are tested based on the following models: ABS_DA=α0+α1IFRSit+α2BIG4it+α3GROWTHit+α4SIZEit+α5 LEVit+α6ROEit+α7REALit+εit (7) REAL=α0+α1IFRSit+α2 BIG4it+α3GROWTHit+α4SIZEit+α5 LEVit+α6ROEit+α7ABS_DAit+εit (8) where ABS_DA=absolute value of accrual earnings management; REAL=total value of real earnings management; IFRS=dummy variable, 1 for 2012-2014 periods and 0 otherwise. We used several control variables including growth (GROWTH), audit size (BIG4) financial leverage (LEV), firm size (SIZE) and profitability (ROE). BIG4 is a dummy variable indicating that whether the firms hired a Big 4 auditor, GROWTH is measured as the sales change

1**to control for the growth on earnings management.**

In order

27**to control for the effect of firm size on earnings management,**

40**we measure SIZE as the natural logarithm of** firm's **market value.**

35**LEV is** the **firm's** financial **leverage** which is **the** proportion **of total liabilities to**

5**as the ratio of total liabilities to** prior **year's total assets. Return on equity (ROE)** is measured **as** the **net income** over **last year's shareholders equity.** Researches **(for**

example Doukakis 2014 and Zang 2012) have also concluded that real earnings management is conducted when firms do not have enough flexibility in earnings management through accrual discretions. Therefore, we also use accrual-based earnings management (ABS_DA) as one of the control variables for the real earnings management regression. RESULTS

12**Descriptive Statistics The descriptive statistics of** model **are** shown on the **Table 1. The** variable ABS_DA indicates an average of 0.108 which means that the average value of accruals that generated by management discretion compared to the previous year assets on manufacturing company in Indonesia. Our study also indicates that 40.6% of our sample was being audited by BIG4. The variable sales growth (GROWTH) have an average value of 0.097 which shows that the average sales increase against the previous year on manufacturing company in Indonesia is 9.6%. While 45.1% of assets are financed by debt, the average of return of equity was 12.4%. Table 1 DESCRIPTIVE STATISTICS N Mean Maximum Minimum Std. Dev. REAL 438 1.113 2.783 -0.152 0.499 ABS_DA 438 0.108 0.416 0.001 0.074 SIZE 438 21.131 25.17 18.060 1.482 GROWTH 438 0.097 0.800 -0.499 0.183 LEV 438 0.451 0.914 0.0413 0.193 ROE 438 0.124 0.591 -0.271 0.117 IFRS 438 0.500 1.000 0.000 0.500 BIG4 438 0.406 1.000 0.000 0.491 Notes: ABS_DA: Accrual

23**Earnings Management; REAL:** Total Real **Earnings Management; IFRS:** IFRS **Adoption,** Dummy **1**

after IFRS Adoption from Year 2012-2014, 0 Prior to IFRS Adoption from Year 2009- 2011; BIG4: Type of Auditor, Dummy 1 Audited by BIG4, 0 Audited by Non BIG4; GROWTH: Sales Growth; SIZE: Firm Size; LEV: Leverage; ROE: Return on Equity The correlation statistics which are displayed in Table 2 showed that discretionary accrual has a positive relationship with

16**real earnings management. On the** other hand, the **real earnings management is**

negatively correlated with the audit size (BIG4) and profitability (ROE) and positively correlated with leverage (LEV).

12**Table 2 CORRELATION RESULTS 1 2 3 4 5 6 7 8**

1 ABS_DA 1 2 REAL 0.143*** 1 3 IFRS 0.037 0.027 1 4 BIG4 -0.021 -0.200*** 0.028 1 5 SIZE 0.006 -0.082 0.134*** 0.344*** 1 6 GROWTH 0.076 -0.054 0.073 0.008 0.082 1 7 LEV 0.066 0.479*** -0.015 -0.180*** 0.247*** 0.038 1 8 ROE 0.027 -0.109** -0.140*** 0.249*** 0.060 0.235*** -0.182*** 1 Source: EVIEWS output, 2016 **

25**significant at the 0.05 level *** significant at the 0.01 level** Panel Regression **Table** 3 presents **the** regression analysis results **of**

regression model (7) and regression model (8). Our statistics indicate that the models satisfy all the classical assumptions. For example, as appeared in Table 3 the VIF scores are all less than 10, indicating no serious multicollinearity issue. We also corrected the standard errors for their possible biases due to heteroscedasticity using the White’s method. As been highlighted earlier, we also conducted the Hausman test to control for time and cross sectional heterogeneity. The tests indicate that fixed effect model is used for the discretionary accrual and random effect model is used for the real earnings management. On the first model where the dependent variable is the accrual earnings management the adjusted R-squared value is 0.489. This indicates that the discretionary accrual is explained by the variation of IFRS and all the control variables (BIG4, SIZE, GROWTH, LEV, ROE and REAL) by 48.9%. F-statistics (6.292) for this is also significant at 1% indicating that all the variables significantly affect discretionary accrual. The first hypothesis (H1) is regarding the adoption of IFRS that may have a positive association with the change in accrual earnings management practices. Our regression results showed that IFRS adoption has a lower discretionary accrual by 2.1% as compared to the firms that have yet to implement IFRS (t-value=-2.713). Surprisingly, our finding cannot confirm our hypothesis that earnings management is increased after IFRS convergence. Rather we found that inverse association in which earnings management is reduced following IFRS convergence. We also test whether real earnings management is increased after the infusion of IFRS. The Adjusted R-squared of this particular model is 0.259. In this regards, we found that

17**real earnings management is higher in the post IFRS**

implementation by 5.2% as compared to the prior IFRS implementation (t-value=2.522; p=0.0120). Table 3 REGRESSION RESULTS FROM THE POOLED SAMPLE Estimate (t-value) Variance Inflation Factors (VIF) ABS_DA REAL ABS_DA REAL Constant -1.572*** (-4.646) 2.400*** (4.009) IFRS -0.021*** (-2.714) 0.052** (2.522) 1.068 1.062 BIG4 -0.020 (-0.858) -0.070 (-0.997) 1.298 1.296 SIZE 0.070*** (4.422) -0.076*** (-2.844) 1.370 1.311 GROWTH 0.005 (0.297) -0.219*** (-3.549) 1.093 1.090 LEV 0.035 (0.815) 0.476*** (4.031) 1.596 1.205 ROE 0.145*** (2.673) -0.213 (-1.323) 1.202 1.201 REAL 0.150*** (7.650) 1.396 ABS_DA 1.484*** (8.833) 1.012 Adjusted R² 0.489 0.259 F-statistic 6.292*** 22.827*** Hausman Prob 0.00 1.00 Source: EVIEWS output, 2016 Notes: ABS_DA: Accrual Earnings Management; REAL: Total Real Earnings Management; IFRS: IFRS Adoption, a dummy variable in which 1 is after IFRS adoption from year 2012-2014, 0 prior IFRS adoption from year 2009-2011; BIG4: Auditor Type, a dummy variable in which 1 is audited by BIG4 and 0 otherwise; GROWTH: Sales Growth; SIZE: Firm Size; LEV: Leverage; ROE: Return on Equity **

4**significant at the 0.05 level *** significant at the 0.01 level**

However, as sensitivity tests, when we decompose the real earnings management intro its three known activities, we found that Earnings management is lowered in the post IFRS implementation only from sales management activities (i.e., abnormal cash flow from operations, ABN CFO, t=-1.962) and reduction of discretionary expenses (AB_DISEXP, t=- 3.135). Nevertheless, we cannot find that real earnings management through over production (ABN_PROD) is different in the post, vis a vis, pre IFRS implementation (t=0.348) (Table 4). Table 4 REGRESSION RESULTS FOR INDIVIDUAL PROXIES REAL

7**EARNINGS MANAGEMENT ABN_CFO ABN_PROD ABN_** DISEXP Constant **0.** 023 **(0.**

251) -1.412***(-3.507) -5.806***(-6.549) IFRS -0.011*(-1.962) 0.003(0.348) -0.068***(-3.135) BIG4 0.036*** (2.754) 0.006(0.165) 0.090(1.099) SIZE 0.003(0.646) 0.060***(3.157) 0.222***(5.263) GROWTH -0.070*** (-4.449) 0.041**(1.986) 0.318***(6.885) LEV -0.150***(-5.518) 0.250***(4.987) 0.137(1.245) ROE 0.403*** (11.237) -0.374***(-6.648) -0.443***(-3.581) REAL ABS_DA -0.756***(-17.618) 0.269***(4.472) -0.519*** (-3.922) Adjusted R² 0.540 0.893 0.857 F-statistic 74.383*** 47.084*** 34.280*** Source: EVIEWS output, 2016 Notes: ABN_CFO: Abnormal Value

30**of Cash Flow from** Operation; ABN **_PROD: Abnormal** Value **of Production;** ABN **_DISEXP: Abnormal** Value **of**

Discretional Expenses; ABS_DA: Accrual

23**Earnings Management; REAL:** Total Riil **Earnings Management; IFRS:** IFRS **Adoption,** dummy **1**

after IFRS adoption from year 2012-2014, 0 before IFRS adoption from year 2009-2011; BIG4: Type of Auditor, dummy 1 audited by BIG4, 0 audited by non BIG4; GROWTH: Sales Growth; SIZE: Firm Size; LEV: Leverage; ROE: Return on Equity *

15**significant at the 0.** 10 **level ** significant at the 0.05 level *** significant at the 0.** 01 **level** DISCUSSION AND CONCLUSION **This** study tests **the** impacts **of**

1**mandatory IFRS adoption on earnings management**

from Indonesian manufacturing firms. Although prior researches have put serious attention on how IFRS may affect the earnings management behaviour, but they

22**tend to** focus **more on accrual-based earnings management.**

This study however tries to focus both on accounting (i.e., discretionary accrual) and operational aspects of earnings management, namely real earnings management. Based on a sample of 438 observations from Indonesian Stock Exchange (IDX) for fiscal years of 2009 to 2014, we found several interesting findings. First, adoption of IFRS has a negative association with accrual earnings management. It means therefore, there is a decrease in the level of discretionary accruals on manufacturing companies in Indonesia after a period of implementation of IFRS. In line with Doukakis (2014), the implementation of IFRS may increase the firm's transparency and improve the overall quality of financial reporting. In this case, analysts, investors, capital market authority are at better position to evaluate and monitor firms' accounting quality and may make informed decision based on firms' accounting options and basic assumptions. As a consequence, managers may not be at ease to falsify or manipulate its performance in their financial reports. Zeghal (2012) also mentioned

31**that the adoption of IFRS** improves **the quality of** earnings **by** limiting **the** selection **of**

management decision by eliminating allowed accounting alternative and provide a more consistent approach to accounting measurements. The

19**results of this study are** also **consistent with** a **research**

conducted by

29Sellami and Fakhfakh (2014) and Brad et al. (2006) that found the adoption of IFRS tend to decrease the

earnings management practice based on discretionary accruals. In contrary, we found that real earnings management tend to be higher in the post IFRS period. A trade-off explanation is provided by

1Cohen et al. (2008) maintain that a decline in one type of earnings management may be because of the

substitution of another method of earnings management had already occurred. A survey conducted by Graham (2005) also indicate

9that managers prefer engaging in real earnings management practice rather than accrual earnings management, as real activities

directly affect the cash flow

22(Cohen and Zarowin 2010). Cohen and Zarowin (2010)

also provide further justifications the reasons real earnings management is preferred. As previously mentioned, aggressive accrual earnings management may lead to higher risk of surveillance by the auditor and perhaps, regulators. Second, less flexibility is available when the firms engage in accrual earnings management (i.e., less slack in discretionary accrual for the following periods). This finding also in-line with Zang (2012) that examined the effect of trade-offs between accrual earnings management

34and real earnings management and generate a negative relationship between both earnings management.

Like any other research, this study has also some limitations which is necessary to be mentioned. First, observation on this research is the manufacturing sector. Thus, this research has yet to represent the overall corporate sector in Indonesia Stock Exchange. Second, we do not properly (and comprehensively) test the presence

10of the trade-off between real earnings management and accrual based earnings management and whether the

trade-offs prevails following IFRS adoption. We leave this interesting area for further research. Third, due to data availability, we do not differentiate mandatory vs. voluntary adopters of IFRS and thus their respective outcomes to the earnings management are left unexplored. Fourth, it is also interesting to examine the real earnings management using alternative proxies such as long- term asset sales, stock options, stock repurchases and structuring investment transactions and corporate fundings. REFERENCES Aussenegg,

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