# 1. Profits Management with Classification Shifting: Testing the Impact of Discontinued Operations and Institutional Ownership on Unexpected Core Earnings.

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# Profits Management with Classification Shifting: Testing the Impact of Discontinued Operations and Institutional Ownership on Unexpected Core Earnings

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## Abstract

One of the earnings managements is classification shifting. Besides extraordinary and exclusive items, the companies can discontinue their operations as the classification shifting form. This research intends to prove and analyze the influence of discontinued operations and institutional ownership on unexpected core earnings. The population is non-financial companies in the Indonesian capital market with the stopped operation from 2012 to 2017. After a simple random sampling and a regression model are utilized to sample companies and analyze data, this study infers that discontinued operations negatively affect unexpected core earnings. Unfortunately, institutional ownership does not influence it.

Keywords: Asymmetric Information, Classification Shifting, Discontinued Operations, Unexpected Core Earnings

## 1. Introduction

Managers can use various methods to manage earnings, and the execution depends on the choice of financial report providers to get their expected results (Sun & Rath, 2010). Generally, this management can be incorrectly and correctly done. Removing expense, recording illusory sales, and confessing expense as assets are an example of prohibited action. Conversely, selecting and changing a specific recording method are examples of the permissible (Hafni, 2012).

According to Barua, Lin, & Sbaraglia (2010), earnings management can be governed by the classification shifting besides managing the accrual and manipulating activities. This shifting can be facilitated through extraordinary substances (Mcvay, 2006) and unique items (Fan, Barua, Cready, & Thomas, 2010), and terminated operations (Barua et al., 2010). In Indonesia, the research utilizing the classification setting through stopped operation is still rare. For example, using the company data from the Indonesian capital market in 2014, Anthonius and

Murwaningsari (2018) demonstrate a positive effect of these operations on unforeseen fundamental earnings. In contrast, Debbianita, Siregar, and Adhariani (2016) locate a negative relationship after utilizing the companies listed in Indonesia, Singapore, Malaysia, and the Philippines between 2011 to 2014.

Because of the contrary evidence, this study will prove the influence of stopped operation on unexpected core profits. As the modification of the research model, this study uses four years, i.e., 2013, 2014, 2015, and 2016. It also increases one determinant of these unexpected core earnings, i.e., institutional ownership, by applying the relevant Indonesian companies in the capital market as the samples.

## 2. Literature Review and Hypothesis Development

### 2.1. Stopped operation and Unexpected Core Earnings

Barua et al. (2010) explain that classification shifting through discontinued operations is problematic because *the International Financial Reporting Standards* (IFRS) require detailed disclosure for them. According to IFRS No. 5, this disclosure is reported in the comprehensive income. It consists of total profit or loss after-tax from the stopped operation and the confessed gain or loss to measure the fair value after subtracting from costs to sell or dispose of the assets related to this operation. Furthermore, this single amount must be presented and separated from continued operation. By knowing it, the asymmetric information between public investors and managers will be lower, and this situation decreases unexpected core earnings. Based on this information, this research proposes the first hypothesis:

$H_1$: Stopped operations negatively influence unpredictable core earnings.

### 2.2. Institutional Ownership and Unexpected Core Earnings

By excellent monitoring, the institutions can prevent the managers from organizing the earnings, reducing agency costs (Alzoubi, 2016). When this tendency decreases, the asymmetric information between companies and their investors will be lower. Therefore, this situation cut the unexpected core earnings (Barua et al., 2010). Based on this information, this research proposes the second hypothesis:

$H_2$: Institutional ownership negatively influences unpredictable core earnings.

### 2.3. Research Model

Furthermore, we draw the research model in Figure one based on the two relationships stated above.
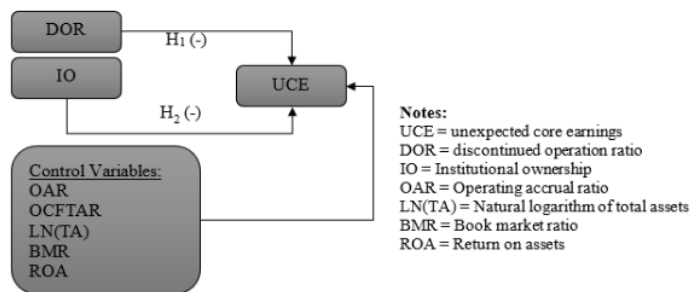
Figure 1: Research Model

## 3. Research Method

### 3.1. Research Variable Measurement

This study employs three types of variables. Firstly, the explained, i.e., unexpected core earnings. The second is the stopped operation and institutional ownership as the first and second primary independent variables. Lastly, following Barua et al. (2010), we utilize operating accrual, operational cash flow, firm size, growth prospect, profitability as the control variables. Moreover, the measurement exists in Table 1.

Table 1: Variable Measurement

| Research Variable | Indicator | Scale |
|---|---|---|
| Unexpected core earnings | The difference between the reported and estimated earnings* at the end of the year, symbolized by UCE | Ratio |
| Discontinued operation | Stopped operation value multiplied by minus one divided by total revenue at the end of the year, symbolized by DOR | Ratio |
| Institutional ownership | The percentage of shares of the institution at the end of the year, symbolized by IO | Ratio |
| Operating accrual | The difference between net earnings before extraordinary items and operating cash flow divided by the revenue, symbolized by OAR | Ratio |
| Operational cash flow | Operating cash flow to total asset ratio at the end of the year symbolized by OCFTAR | Ratio |
| Company size | Natural logarithm of total assets at the end of the year, symbolized by LN(TA) | Ratio |
| Growth prospect | The book to market value ratio at the end of the year, symbolized by BMR | Ratio |
| Profitability | The return on the asset at the end of the year, symbolized by ROA | Ratio |

*Note: To calculate reported earnings, we utilize the core earnings, symbolized by CE, in the income statement by subtracting the cost of goods sold and non-depreciation expenses: sales, general, and administration, from revenue. The removal of depreciation expenses is due to the accounting effect avoidance from the write-downs already deducted by depreciation. Meanwhile, we compute the predicted core earnings by employing the regression model utilized by McVay (2006) in the first equation:

$CE_t = \gamma_0 + \gamma_1 CE_{t-1} + \gamma_2 TATO_t + \gamma_3 OAR_{t-1} + \gamma_4 OAR_t + \gamma_5 \Delta REV_t + \gamma_6 DNEG\_\Delta REV_t + \varepsilon_t$ (Eq. 1), where TATO is the total asset turnover ratio, OA = operating accrual, t and t-1 are the notation for the current and previous years, $\Delta REV$ is the change in revenue, $DNEG\_\Delta REV$ is dummy variable: 1 for the negative delta, and vice versa.

### 3.2. Population and Sample

The population in this research is the non-financial companies in the Indonesian capital market from 2012 and 2017 having the amount of discontinued operations. Unfortunately, not all companies have this value. Therefore, we selected them from the existing data from the financial reports and finally obtained 28 companies. Moreover, this number becomes population size (PS), and to calculate the sample number (SN), we employ the Slovin formula with the 10% fault border (FB) in Suliyanto (2009) (see the second equation).

$$SN = \frac{PS}{1+(PS \, x \, FB^2)}$$ (Eq. 2)

Using this formula, we get the SN = $\frac{38}{1+(38 \, x \, 10\% \, x 10\%)} = \frac{38}{1.38} = 27.54 \approx 28$ companies. Then, we pick them by simple random sampling. The name of the samples is in the second table.

Table 2: The name of the company as the sample

| No | Code | The name of the company |
|----|------|-------------------------|
| 1. | HERO | Hero Supermarket Tbk |
| 2 | EMTK | Elang Mahkota Teknologi Tbk |
| 3 | SMCB | Holcim Indonesia Tbk |
| 4 | ELTY | Bakrieland Development Tbk |
| 5 | INDF | Indofood Sukses Makmur Tbk |
| 6 | IIKP | Inti Agri Resources Tbk |
| 7 | RDTX | Roda Vivatex Tbk |
| 8 | TINS | Timah (Persero) Tbk |
| 9 | MLPL | Multipolar Tbk |
| 10 | VOKS | Voksel Tbk |
| 11 | MERK | Merck Tbk |
| 12 | ULTJ | Ultrajaya Milk Industry Tbk |
| 13 | ELSA | Elnusa Tbk |
| 14 | EXCL | Xl Axiata Tbk |
| 15 | SILO | Siloam International Hospital Tbk |
| 16 | BBRI | Bank Rakyat Indonesia Tbk |
| 17 | META | Nusantara Infrastructure Tbk |
| 18 | ISAT | Indosat Tbk |
| 19 | ROTI | Nippon Indosari Tbk |
| 20 | BIRD | Blue Bird Tbk |
| 21 | PJAA | Pembangunan Jaya Ancol Tbk |
| 22 | ANTM | Aneka Tambang Tbk |
| 23 | MEDC | Medco Energi Internasional Tbk |
| 24 | ERTX | Eratex Djaja Tbk |
| 25 | MYRX | Hanson International Tbk |
| 26 | SUGI | Sugih Energy Tbk |
| 27 | GOLD | Visi Telekomunikasi Infrastruktur Tbk |
| 28 | LINK | Link Net Tbk |

### 3.3. Data Analysis Method

This applies the regression model to investigate the data. Furthermore, the intended model is in the third equation:

$$UECE_{it} = \beta_0 + \beta_1 DOR_{it} + \beta_2 IO_{it} + \beta_3 OAR_{it} + \beta_4.OCFTAR_{it} + \beta_5 LN(TA)_{it} + \beta_6 BMR_{it} + \beta_7.ROA_{it} + \varepsilon_{1it}$$
(Eq.3)

This model functions to check $\beta_1$ and $\beta_2$, associated with the first and second hypotheses testing. If the probability of t-statistic for this coefficient is below the 5% significance level, we accept the proposed research hypothesis.

## 4. Results And Discussion

### 4.1. Descriptive Statistics

Descriptive statistics are required to describe the variables based on statistical measurements (Hartono, 2012), for example, the observation number (N), minimum, maximum, mean, standard deviation (Sahabuddin & Hadianto, 2019). Because the samples consist of 28 firms for four years, the N becomes 112, where the details for each variable are in the third table.

Tabel 3: Descriptive Statistics

| Variables | N | Minimum | Maximum | Mean | Standard Deviation |
|-----------|-----|---------|---------|------|--------------------|
| UECE | 112 | -2.62426 | 0.99561 | 0.000000 | 0.34497647 |
| DOR | 112 | -2.2430 | 3.4070 | -0.013398 | 0.4031201 |
| IO | 112 | 2.43 | 100.00 | 59.3927 | 22.78159 |
| OAR | 112 | -7.2177 | 33.5886 | 0.132979 | 3.2697366 |
| OCFTAR | 112 | -0.10 | 0.36 | 0.0838 | 0.08320 |
| LN(TA) | 112 | 10.97 | 15.00 | 12.8182 | 0.78990 |
| BMR | 112 | 0.03 | 4.55 | 0.8847 | 0.94278 |
| ROA | 112 | -7.55 | 25.32 | 4.8067 | 6.44466 |

*Source: The modified output of IBM SPSS 19*

*4.2. The test result of classical assumptions*

This regression model already meets the examination of classical assumptions. (see Table 4), as Ghozali (2016) obliges. Firstly, the residuals have the normal distribution (see the asymptotic significance (2-tailed) in Panel A for the Kolmogorov-Smirnov Z above 5%: 0.054). Secondly, this model is free from multicollinearity, reflected by the variance inflation factor (VIF) below 10: 1.893, 1.238, 1.970, 2.126, 1.302, 1.222, and 2,110 for DOR, IO, OAR, OCFTAR, LN(TA), BMR, and ROA (see Panel B). Thirdly, heteroskedasticity does not exist in this model at the 1% significance level, shown by the Chi-Square probability of Observed R-squared below 1%: 0.0330 (see Panel C). Finally, the regression model is without autocorrelation, demonstrated by the asymptotic significance (2-tailed) in Panel D for Z-statistic above 5%: 0.288.

Table 4: The test result of classical assumptions

| Panel | Classical Assumptions | Statistical Measurement | Value |
|---|---|---|---|
| A | Normality* | Kolmogorov-Smirnov Z | 1.345 |
| | | Asymptotic significance (2-tailed) | 0.054 |
| B | Multicollinearity* | VIF for DOR | 1.893 |
| | | VIF for IO | 1.238 |
| | | VIF for OAR | 1.970 |
| | | VIF for OCFTAR | 2.126 |
| | | VIF for LN(TA) | 1.302 |
| | | VIF for BMR | 1.222 |
| | | VIF for ROA | 2.110 |
| C | White heteroskedasticity**: | Obs*R-squared | 15.246 |
| | RESID^2 = f(DOR, IO, and all | Probability of Chi-Square | 0.0330 |
| | control variables squared) | The total additional independent variables | 7 |
| D | Autocorrelation* | Z-statistic for runs testing | -1.063 |
| | | Asymptotic significance (2-tailed) | 0.288 |

*Source: The modified output of IBM SPSS 19* and E-Views 6***

*4.3. The estimation result of the regression model*

After achieving the classical assumptions, the next step is estimating the regression coefficients and their details, for example, the probability of the t-statistic, where the result is in Table 5. For the primary hypotheses, the relevant possibility is 0.000 for DOR and 0.2854 for IO.

a.  Because the probability for DOR is less than 5%: 0.000, we accept the first hypothesis stating that stopped operations negatively influence unexpected core earnings.

b.  Because the probability for DOR is higher than 5%: 0.2854, we refuse the second hypothesis. Consequently, institutional ownership does not influence unexpected core earnings.

Table 5: The estimation result of the regression model: the influence of discontinued operation and institutional ownership on unexpected core earnings

| Variable | Coefficient | Standard error | t-Statistic | Probability |
|---|---|---|---|---|
| C | -0.368440 | 0.433165 | -0.850576 | 0.3970 |
| DOR | -0.776172 | 0.082853 | -9.368021 | 0.0000 |
| IO | 0.001237 | 0.001152 | 1.073785 | 0.2854 |
| OAR | -0.066808 | 0.010395 | -6.426723 | 0.0000 |
| OCFTAR | -0.491903 | 0.425730 | -1.155434 | 0.2506 |
| LN(TA) | 0.020316 | 0.032200 | 0.630937 | 0.5295 |
| BMR | 0.013892 | 0.028229 | 0.492137 | 0.6237 |
| ROA | 0.012886 | 0.005410 | 2.381866 | 0.0190 |
| R-squared | | 0.489474 | F-statistic | 14.24450 |
| Adjusted R-squared | | 0.455112 | Probability (F-stat) | 0.000000 |

*Source: The modified output E-Views 6*

*4.4. Discussion*

This study reveals that discontinuing operation as the earning management tool decreases the unexpected core earnings. This situation exists because the firms becoming the samples in this study already implement IFRS No. 5, making classification shifting is problematic to execute. This IFRS makes the financial report more transparent by setting the specific disclosure and guideline on these stopped operational activities.

This study reveals that institutional ownership does not affect unexpected core earnings. It means the monitoring function of institutional is not effective in controlling asymmetric information between managers and public investors. The application of IFRS No. 5 is proven as the single solution to handle asymmetric information related to these core earnings.

**5. Conclusion And Suggestions**

This research examines the impact of the discontinued operation and institutional ownership on unexpected core earnings. Furthermore, to attain this aim, this research uses 28 relevant companies as samples in the Indonesian capital market from 2013 to 2016 and the regression model to analyze the data through hypothesis testing. Additionally, after examining two hypotheses, this study concludes: (1) the discontinued operation negatively influences unexpected core earnings, (2) institutional ownership has no effect.

This study has some boundaries: It only utilizes the companies in the Indonesian capital market and two primary determinants of unexpected core earnings. Based on these limitations, we suggest that other scholars activate the relevant companies in the capital market in the Southeast Asia countries. Besides, they can use:
a.      the different measurements of classification shifting, like extraordinary items and unique items;
b.      the other affecting factors of these earnings, such as external auditor reputation.

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PAGE 1

PAGE 2

PAGE 3

PAGE 4

PAGE 5

PAGE 6