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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<sub>1</sub>: 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<sub>2</sub>: 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.

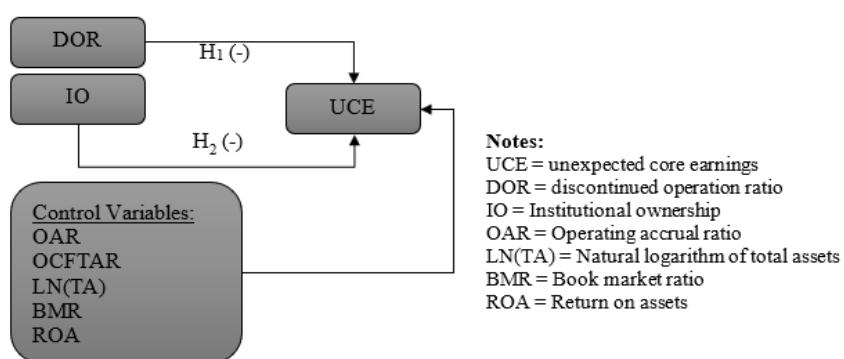


Figure 1: Research Model

### 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:

$CET = \gamma_0 + \gamma_1 CET_{t-1} + \gamma_2 TATO_t + \gamma_3 OA_{t-1} + \gamma_4 OA_{t-1} + \gamma_5 \Delta REV_t + \gamma_6 DNEG\_REV_t + \epsilon_t$  (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,  $DNEG\_REV$  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).

$$SN = \frac{PS}{1 + (PS \times FB^2)} \quad (\text{Eq. 2})$$

Using this formula, we get the  $SN = \frac{38}{1 + (38 \times 10\% \times 10\%)} = \frac{38}{1.38} = 27.54 \approx 28$  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	IIPK	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	XI 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:  

$$\text{UECE}_{it} = \beta_0 + \beta_1 \text{DOR}_{it} + \beta_2 \text{IO}_{it} + \beta_3 \text{OAR}_{it} + \beta_4 \text{OCFTAR}_{it} + \beta_5 \text{LN(TA)}_{it} + \beta_6 \text{BMR}_{it} + \beta_7 \text{ROA}_{it} + \varepsilon_{it}$$
 (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**: RESID^2 = f(DOR, IO, and all control variables squared)	Obs*R-squared	15.246
		Probability of Chi-Square	0.0330
		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:

- the different measurements of classification shifting, like extraordinary items and unique items;
- the other affecting factors of these earnings, such as external auditor reputation.

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