The Influence of Special Items to Core Earnings
in Earnings Management at Manufacturing Companies
Listed in Jakarta Stock Exchange

(Fajar Vishnu Pratama and
Rahmawati)

THE INFLUENCE OF SPECIAL ITEMS TO CORE EARNINGS
IN EARNINGS MANAGEMENT AT MANUFACTURING COMPANIES
LISTED IN JAKARTA STOCK EXCHANGE

Fajar Vishnu Pratama[*]

Rahmawati[**]

Abstract

This paper examines the classification of items within the income statement as an earnings management tool. Evidence is consistent with managers opportunistically shifting expenses from core expenses (cost of goods sold and selling, general, and administrative expenses) to special items. This vertical movement of expenses does not change bottom-line earnings, but overstates ''core'' earnings.

Keywords: *earnings management; earnings components; special items.*

I. Introduction

Financial statements are the main part of financial reporting which can be used as a medium to communicate information for internal parties (such as: manager and employees) and also external parties (such as: stockholder, investor, and government). Financial statement is also a tool to onus what done by management for the owner resource (Belkaoui 1993). Financial statements are aimed at evaluating company's financial position and also utilized as one of the parameters to measuring company's financial performance. Therefore, financial statements gain a special attention to its consumers to make decision by making used of the companies' financial statements hence financial statements have to be presented according to financial accounting-reporting standards.

According to Healy and Palepu in Utami (2005), there are three conditions causing communications through financial statement can be imperfect and is not transparent, these are: (1) compared with investors, managers have more information about their strategy and business operation, (2) manager's interests do not always in harmony with the interests of their investors, and (3) Audit council accountancy perception is imperfect.

Financial Statements consist of balance sheet, income statement, owner's equity statement pursuant to accrual bases, and statement of cash flow pursuant to cash bases. In preparing financial statements, accrual bases is used because it is more rational and fair in

---

[*] Universitas Sebelas Maret
[**] Universitas Sebelas Maret

represent the real condition of financial company, but on the other side using accrual bases can give facility to management parties in choose accounting method during do not digress from Standard of Financial Accounting. From the financial statement, one of the parameter is used to evaluate management performance is profit.

Profit information help owner/other parties in estimating strength of profit to assess risk in investment and credit. Important of the profit information have to be aware by management parties as compiler parties of financial statement and also as parties that are measured its performance. Profit information as expressed in Statement Financial Accounting Concepts of (SFAC) number 2 representing especial element in financial statement and of vital importance to parties that is using it because having predictive value. Information can be controlled in future, resulting cash flow from existing resource, and for the formulation of consideration about company effectiveness in exploiting accretion its resource. For stockholders and investor, profit means the make-up of economic value (wealth) to be accepted through the allocation of dividend. Profit is also used as appliance to measure company management performance during specified period which is on generally become attention of certain parties especially in assessing performance of the management responsibility in manage of resource entrusted for them, and also can utilized to estimate its prospect in future. With the existence of the reason will push incidence of earnings management practice.

When at one particular condition where management parties fail to reach determined profit target, hence management will exploit enabled flexibility by Standard of Financial Accounting in compiling financial statement to modify reported profit. Management motivation to show good performance in resulting maximal value or advantage to company so that management tend to choose and apply accounting method which can give better profit information. Management flexibility to manage of profit can be lessened by providing more information with quality to outside parties. According to Bagnoli and Watts in Utami (2005), earnings management practice more done by management because them assume other company also doing same thing. Thereby, competitor performance also can become incentive to conduct earnings management practice because investor and creditor will do compare to determine which company have good rating.

Earnings management is management interference in process arrangement of external financial statement utilize to reach certain profit level with purpose to advantage theirself or their company (Setiawati and Saputro, 2004). Tone matter is also laid open by Scott (2003), that earnings management represent election of accounting policy by manager from existing standard of accounting and scientifically can maximize their advantage and company market value.

While according to Copeland in Utami (2005), earnings management include the effort management to maximize or minimize profit, including flattening of profit as according to desire of management. Rosenzweig and Fischer (1995) in Achmad and Subekti (2007) expressing, earnings management represent manager action to increase (decrease) reported profit in this time from the unit becoming manager responsibility without correlating with improvement (decreasing) long-range economic profitability.

Accrual bases have to be held by management parties in arranging of financial statement is included in reporting profit. Accrual accounting consists of Discretionary Accruals and Non Discretionary Accruals. Discretionary Accruals represent accrual, which

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

is determined by management. Manager can choose policy in the case of method and accounting estimation. Discretionary Accruals also give rope for management to determine the amount of accrual transaction. Determination of reserve loss of receivable, which will increase receivable with cleanness, increasing inventory, decreasing accounts payable, and accrual liabilities represent example of Discretionary Accruals.

While Non-Discretionary Accruals represent determined accrual for the condition of economics. Non Discretionary Accruals also mean noted transaction by using one procedure, if the procedure selected hence management expected to consistence in using procedure, which has been selected. Total of accrual from a company represent proxy from accrual accounting policy, which is flange at earnings management action. This matters because management to influence reported profit so that difficult to be detected often uses policy, which is related to accrual. Therefore, many researchers doing detection for earnings management use total of accrual as proxy from earnings management. Setiawati and Na'im in Margaretha (2004) expressing that earnings management represent one of the factors, which can lessen financial statement credibility. Earnings management adds diffraction in financial statement that trusting profit number result of engineering mentioned as profit number without engineering. Hence detection for earnings management indication in financial statement becomes to need to be done.

Earnings management, misclassification, and close over real correct economics performance, have come to focus from many article. Much research, which is focused at two general earnings management appliance that is: accrual management and real economic activities manipulation. Where accrual management is usually related to all activity which can influence of cash flow as well as advantage which personally represent authority from managers, while real economic activities manipulation done by management parties to show good performance in resulting maximal value or advantage for company to get attention investor and also creditor.

This study examines other earnings management tool, that is: misclassification items in income statement (classification shifting). This study has an argument that managers expect to maximize reported performance by decreasing expenses or increasing revenue in income statement to present a picture, which is not consistent with real economic situation. Classification shifting different with accrual management and real economic activities manipulation in some cases. First, classification shifting do not change GAAP profit, and the second is classification shifting facilitate analysis by grouping items having similar characteristic. Besides there are difference between accrual management and real economic activities manipulation with classification shifting, there is also some equation between third the earnings management method, that is: both of the same is having of high expectation to future performance.

For the method of classification shifting, my concentrate on cost allocation between core expenses (cost of goods sold, and selling expense, and also general and administrative expense) and special items. Classification shifting method is done with examination to the core earnings and special items.

This research is a replication research from research done by Phillips (2003) finding that accrual management represent one of the earnings management tool which is often used by managers as well as research which is done by Bushee (1998) finding that real economic activities manipulation also represent earnings management tool which is often used by managers, hence my research examine the other earnings management tool,

that is: classification shifting (an examination of core earnings and special items) to know whether managers classify core expenses as special items and whether special items have influence for core earnings.

If result of this research succeed to prove that managers classify core expenses as special items and special items have influence for core earnings, hence result of this research as according to research which is done by Mc Vay (2005) using classification shifting (an examination of core earnings and special items) as a means of earnings management.

This research use manufacturing business sample which is there are in Jakarta Stock Exchange at period 2000-2005, use of this period is meant to know what is result of research consistent with research previously.

The paper proceeds as follows. Section II provides some background and develops the hypotheses. Section III discusses the data and provides descriptive statistics. Section IV introduces the model of core earnings, and Section V describes the tests and results. Section VI concludes and offers avenues for future research.

II. Motivation and Hypotheses

Prior accounting research has documented two main methods of earnings management. The most commonly studied method is accrual management. 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. 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.

Again, a third potential earnings management tool is the misclassification of items within the income statement (classification shifting). Classification shifting bears a relatively low cost: there is no accrual that neither later reverses, nor are there lost revenues from forgone opportunities. Moreover, because the allocation of expenses to specific accounts can be subjective, auditors might be limited in their ability to verify the appropriate classification, and, because bottom-line income does not change, they might expend less energy on the identification or compulsory adjustments of these accounts.

Reason of researcher interest to investigate again classification shifting earnings management tool (an examination of core earnings and special items) because most of research antecedent only examine earnings management tool which is used occasionally by managers that is: accrual management and real economic activities manipulation, while other earnings management tool, that is: classification shifting (an examination of core

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

earnings and special items) seldom get attention from researcher. Classification Shifting do not fail nicely by means of other earnings management, even have excellence in comparison with other earnings management tool, for example: accrual management and real economic activities manipulation. But why researcher very rare to lift the topic of classification shifting problem (an examination of core earnings and special items).

Therefore, we are interested in investigating classification shifting problem (an examination of core earnings and special items) this such as those, which have been done beforehand by Mc Vay. I also wish to prove what have been done beforehand concluded by Mc Vay that managers classify core expenses as special items and special items have influence for core earnings.

Focusing on classification shifting between core expenses and special items offers a powerful test of classification shifting for several reasons. First, core expenses and special items are clearly distinct; core expenses tend to be relatively stable, while special items are by definition unusual or infrequent. Special items have been shown to be highly transitory and are treated accordingly by investors. Therefore, classification shifting between core expenses and special items, if not fully disentangled by financial statement users, can impact expectations and thus prices. Moreover, special items tend to be excluded from core earnings by both managers and thus classification shifting from core expenses to special items could result in managers ex post meeting the analyst forecast when they otherwise would not have met this benchmark. Finally, as noted above, the shifting of expenses between core expenses and special items is viable; managers have subjectivity over the classification of expenses, and the shifting is not expected to raise red flags for outside monitors. This leads to my first Hypothesis:

H1: Managers classify core expenses as special items.

In particular, I expect unexpected core earnings to be increasing in special items in year t. Furthermore, to ensure that this is due to classification shifting rather than an economic improvement associated with the special item, we expect this improvement to ''reverse'' in year t + 1 as the core expenses excluded in year t recur in year t + 1.

Clearly there are costs to classification shifting. In addition to the cost of detection, in general, managers want to avoid raising future expectations of investors or other parties. Therefore, we expect managers to classification shift to a greater degree in periods when the benefits to shifting are greater (holding costs to shifting constant). Benefits are expected to be particularly high when the earnings management allows the manager to meet earnings benchmarks. The consensus analyst forecast has become the most important earnings benchmark in recent years and this benchmark typically excludes special items and other nonrecurring charges.

H2: Special items have influence for core earnings.

This research uses four theoretical frameworks. First and second theoretical framework addressed for the hypothesis of is first, while theoretical framework third and fourth addressed for the second hypothesis. First theoretical framework addressed for the first hypothesis, where this research use six independent variables and one dependent variable. Independent variable which is used are CE_{t-1} (Lagged Core Earnings), ATO_t (The

Asset Turnover Ratio, calculated as $\dfrac{Sales_t}{NOA_t+NOA_{t-1}/2}$, $ACCRUALS_{t-1}$ (Prior- Operating Accruals), $ACCRUALS_t$ (Operating Accruals, calculated as [Net Income before Extraordinary Items – Cash from Operations] / Sales, $\Delta SALES_t$(Percent Change in Sales, calculated as ($SALES_t$ - $SALES_{t-1}$)/ $SALES_{t-1}$), $NEG\_\Delta SALES_t$ (*Percent Change In Sales* ($\Delta SALES_t$), if $\Delta SALES_t$ is less than 0 and 0 otherwise). While, it's dependent variable is CE_t (*Core Earnings*).
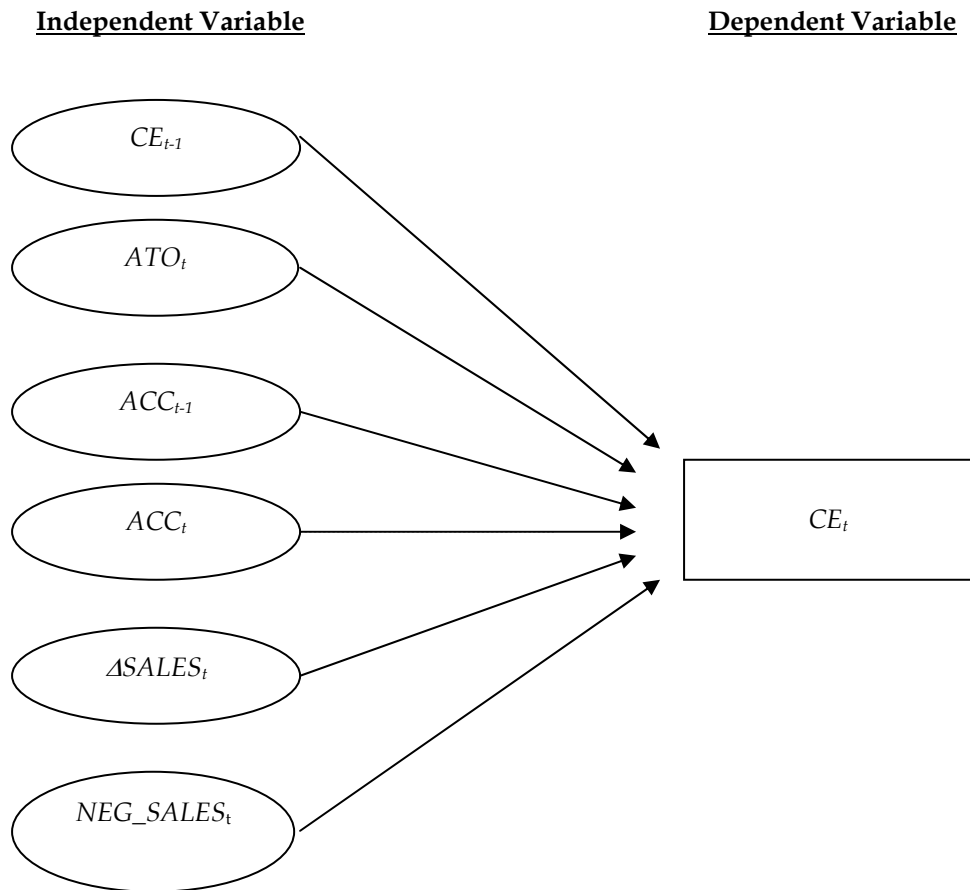
Second, theoretical framework addressed for the first hypothesis, where this research use seven independent variables and one dependent variable. Independent variable which is used are *CE_{t-1}* (Lagged Core Earnings), *ΔCE_{t-1}* (*The Change in Core Earnings*, calculated as *CE_{t-1}* - *CE_{t-2}*), *ΔATO_t* (*Change In Asset Turnover*, calculated as *ATO_t* - *ATO_{t-1}*), $ACCRUALS_{t-1}$(Prior-Operating Accruals), $ACCRUALS_t$ (Operating Accruals, calculated as [Net Income before Extraordinary Items – Cash from Operations] / Sales, *$\Delta SALES$* (Percent Change in Sales, calculated as($Sales_t$ – $Sales_{t-1}$)/ $Sales_{t-1}$, $NEG\_\Delta SALES_t$ (*Percent Change In Sales* ($\Delta SALES_t$), if $\Delta SALES_t$ is less than 0 and 0 otherwise). While, its dependent variable is ACE_t (*The Change in Core Earnings*).

Third theoretical framework addressed for the second hypothesis, where this research use one independent variable and one dependent variable. Independent variable, which is used, is *$\%SI_t$* (*Income-Decreasing Special Items* as a *Percentage of Sales*, calculated as [Special Items$_t$ x 1]/Sales, when *Special Items* are income decreasing and 0 otherwise). While, it's dependent variable is UE_CE_t (*Unexpected Core Earnings*).

Fourth theoretical framework addressed for the second hypothesis, where this research use one independent variable and one dependent variable. Independent variable, which is used, are $\%SI_t$ (*Income-Decreasing Special Items* as a *Percentage of Sales*, calculated as [Special Items$_t$ x 1]/Sales, when *Special Items* are income decreasing, and 0 otherwise). While, its dependent variable is *$UE\text{-}\Delta ACE_{t+1}$* (*Unexpected Change in Core Earnings*).

The Influence of Special Items to Core Earnings	(Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies	Rahmawati)
Listed in Jakarta Stock Exchange

Research Model I

Correlation between, CE_{t-1} , ATO_t , $ACCRUALS_{t-1}$, $ACCRUALS_{t,}$ $\Delta SALES_t$, **and** $NEG\text{-}\Delta SALES_t$ **with** CE_t

<u>**Independent Variable**</u>   <u>**Dependent Variable**</u>

Research Model II

Correlation between, CE_{t-1} , ΔCE_{t-1} , ΔATO_t, $ACCRUALS_{t-1}$,$ACCRUALS_t$, $\Delta SALES_t$, **and** NEG-$\Delta SALES_t$ **with** ΔCE_t

<u>**Independent Variable**</u>   <u>**Dependent Variable**</u>

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

Research Model III
Correlation between $\%SI_t$ **with** UE_CE_t

Independent Variable   **Dependent Variable**

$\%SI_t$ → UE_CE_t

Research Model IV
Correlation between $\%SI_t$ **with** UE_CE_{t+1}

Independent Variable   **Dependent Variable**

$\%SI_t$ → UE_CE_{t+1}

III. Research Approach

A. Data and Sample Selection

This study uses sample consisting of financial statements (annual report) of companies under manufacturing business which enlists in Jakarta Stock Exchange during year 2000-2004. Source of this research data are (1) Database available at Magister Science Gadjah Mada University, and (2) Indonesian Capital Market Directory (ICMD).

Technique intake sample, which is used in this research by using sampling purposive that is, required sample to be limited at certain type or adjust specified criteria by researcher. Population rightful claimant member selected as sample subject is to fulfill certain consideration and criteria. Criteria, which must be fulfilled at company taken, as sample shall be as follows:

1. Manufacturing business which enlist in Jakarta Stock Exchange and publicize audit financial statement consistently and complete from the year 1999 up to 2005.
2. Period of financial statement end every 31 December.
3. Company financial statement use Indonesian currency.

4. Company do not merger, acquisition, and change of other effort (divestiture).

This research use data from manufacturing business financial statement, which enlist in Jakarta Stock Exchange. Pursuant to criteria intake of sample, which have been told above, hence can be obtained research sample as follows.

Table I
Criteria companies taken as sample

Total companies listed in Jakarta Stock Exchange during period 1999-2005	339
Total non-manufacturing companies	(146)
Total manufacturing companies	193
Total companies which not complete / not valid	149
Total companies taken as study sample	44

Source: *Indonesian Capital Market Directory* (ICMD) 1999-2005

From company sample list, which is obtained hence, next step is to collect company's finance data sample above. From Table I, it can be understood that the number of companies taken as sample in this research counted 44 companies.

B. Descriptive Statistics

Table II summarizes descriptive statistic from research variable for the sample of public manufacturing business as a whole from year 1999-2005. Descriptive statistic in this research is presented to give information concerning research variable characteristic cover minimum values, maximum, mean, and deviation standard.

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

Table II
Descriptive statistic of research variable

Variable	N	Minimum	Maximum	Mean	Deviation Standard
CE_t	254	1,361728	6,824362	4,903706	0,869923
ΔCE_t	165	2,406540	6,982114	4,535606	0,827806
UE_CE_t	204	3,615690	6,900879	5,066111	0,402742
$UE\_\Delta CE_{t+1}$	251	4,089088	7,000055	5,224117	0,393810
CE_{t-1}	308	-7.788.340	6.673.623	345.793,6	1.025.683
ΔCE_{t-1}	308	-2.926.467	2.872.738	32.780,51	303.151,4
ATO_t	308	0,040392	3,146351	1,007932	0,578530
ΔATO_t	308	-2,012601	1,245674	0,041392	0,262649
$ACCRUALS_{t-1}$	308	-11,98160	2,837400	-0,182019	0,796590
$ACCRUALS_t$	308	-11,98160	2,837400	-0,131551	0,761249
$\Delta SALES_t$	308	0,000000	13,43020	0,283978	0,891171
$NEG\_\Delta SALES_t$	308	0,999100	0,000000	-0,054027	0,147734
$\%SI_t$	308	-1,196971	0,000000	-0,030918	0,112616

From above data can be known that mean of core earnings for the manufacturing business is 347747, 6 and this number of its value is positive. The mentioned designate that year period 1999-2005 manufacturing business in Indonesia conduct action earnings management by maximizing its core earnings.

Pursuant to result of descriptive statistic which outlined in to the hence also can be known each of CE_{t-1} and ΔCE_{t-1} mean that Indonesia manufacturing business is 345793,6 and 32780,51. Also can be known each have ATO_t and ΔATO_t meant that Indonesia manufacturing business is 1,007932 and 0,041392. While each of $ACCRUALS_{t-1}$ and $ACCRUALS_t$ mean is - 0,182019 and - 0,131551. For the mean of $\Delta SALES_t$, $NEG\_\Delta SALES_t$, and $\%SI_t$ Indonesia manufacturing business each of 0,283978, - 0,054203, and - 0,030918.

C. Measuring Classification Shifting

In Section II, we hypothesize that managers shift core expenses to special items; in this section, we develop a methodology to measure classification shifting. We expect core earnings of special-item firms to be overstated in the year the special item is recognized. We model the level of core earnings, and anticipate unexpected core earnings (reported core earnings less predicted core earnings) in year t to be increasing with special items in year t if managers are classification shifting. As discussed above, an alternative explanation for this association is that core earnings are unexpectedly high due to the immediate benefits of the restructuring charge or some other real economic event. In order to distinguish between real economic changes and the opportunistic behavior of managers,

I examine whether the improvement associated with special items in year t reverses in year t + 1.

To test this part of the Hypothesis, we model the change in core earnings. We expect the unexpected change in core earnings from year t to t + 1 to be declining in special items in year t. Thus, operationally, we expect firms that classification shift to have both (1) a higher than expected level of core earnings in year t and (2) a lower than expected change in core earnings in year t + 1. This prediction is opposite to what is expected to occur in the normal course of business as a result of special items. Referring to Figure 1, reported core earnings for large income-decreasing special-item firm's fall, on average, in the year the special item is recognized, and improves, on average, in the next year.

We develop a model of expected core earnings, first in levels (to examine year t) and then in changes (to examine year t + 1). This model attempts to control for economic performance as well as for macroeconomic and industry shocks. To model the level of, and change in, core earnings (CE), to test H_1, we estimate the following models, respectively. Regressions are estimated by industry and fiscal year:

$$CE_t = \beta_0 + \beta_1 CE_{t-1} + \beta_2 ATO_t + \beta_3 ACCRUALS_{t-1} + \beta_4 ACCRUALS_t$$
$$+ \beta_5 SALES_t + \beta_6 NEG\_\Delta SALES_{t+} \quad \varepsilon_t \tag{1}$$

$$\Delta CE_t = \Phi + \Phi_1 CE_{t-1} + \Phi_2 \Delta CE_{t-1} + \Phi_3 \Delta ATO_t + \Phi_4 ACCRUALS_1 + \Phi_5 ACCRUALS_t$$
$$+ \Phi_6 \Delta SALES_t + \Phi_7 \Delta NEG\_SALES_t + v_t \tag{2}$$

Definition:

CE_t = *Core Earnings (before Special Items and Depreciation), Calculated as (Sales – Cost of Goods Sold – Selling, General, and Administrative Expenses), where Depreciation and Amortization excludes Cost of Goods Sold, Selling, General, and Administrative Expenses.*

CE_{t-1} = *Lagged Core Earnings.*

ΔCE_t = *The Change in Core Earnings*, calculated as CE_{t-1} - CE_{t-2}.

ATO_t = *The Asset Turnover Ratio*, calculated as $\dfrac{Sales_t}{NOA_t + NOA_{t-1}/2}$.

$ACCRUALS_{t-1}$ = *Prior-Year Operating Accruals.*

$ACCRUALS_t$ = *Operating Accruals*, calculated as [Net Income before. Extraordinary Items – Cash from Operations] / Sales.

$\Delta SALES_t$ = *Percent Change in Sales*, calculated as $(Sales_t - Sales_{t-1})/Sales_{t-1}$.

$NEG\_\Delta SALES_t$ = *Percent Change In Sales* ($\Delta SALES_t$ - $SALES_{t-1}$)/ $SALES_{t-1}$, if $\Delta SALES_t$ is less than 0 and 0 otherwise.

ε_t = *Error.*

ΔATO_t = *Change in Asset Turnover*, calculated as ATO_t - ATO_{t-1}.

In the levels model (model I), my first variable is lagged core earnings (CE_{t-1}). We include this variable because core earnings tend to be very persistent (note the correlation

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

of 0.80 between core earnings and lagged core earnings in Table III). Next, we include the asset turnover ratio (ATO_t), as it has been shown to be inversely related to profit margin (e.g., Nissim and Penman 2001), and my definition of core earnings closely parallels profit margin. Note the negative correlation between core earnings and asset turnover in Table III, consistent with the studies referenced above. For the purpose of this paper, the inclusion of the asset turnover ratio is also important because firms that have large income-decreasing special items are likely to be making changes to their operating strategy, possibly altering their mix of margin and turnover.

Sloan (1996) finds that, holding earnings constant, accrual levels are an explanatory variable for future performance. Specifically, earnings performance attributable to the accrual component of earnings exhibits lower persistence than earnings performance attributable to the cash flow component of earnings. Thus, we include prior-year operating accruals ($ACCRUALS_{t-1}$) in my model of core earnings.

We also include current-year accruals ($ACCRUALS_t$) in my model. Extreme performance is highly correlated with changes in accrual levels (DeAngelo et al. 1994). Specifically, unusually good performance is associated with a large increase in accruals, and unusually poor performance is associated with a large decline in accruals. While it is possible that extreme accruals could be due to accrual management, this paper focuses on earnings management using special items, and therefore controlling for accruals, discretionary or otherwise, allows for a stronger prediction of core earnings.

Although core earnings are scaled by sales, the relation is not expected to be constant because, as sales grow, fixed costs become smaller per sales dollar. Therefore, I include sales growth ($\Delta SALES_t$) as an explanatory variable. I also allow the slope to differ between sales increases and decreases (NEG-$\Delta SALES_t$) because Anderson et al. (2003) find that costs increase more when activity rises than they decrease when activity falls by an equivalent amount.

To model the change in core earnings (model II), we include both lagged core earnings (CE_{t-1}) and the change in core earnings from year t – 2 to t – 1 (ΔCE_{t-1}) to allow the model to vary the degree of mean reversion based on the prior-year's level of core earnings. This is important because mean reversion is typically more extreme in the tails (e.g., Freeman et al. 1982; Fama and French 2000). Inclusion of both levels and changes is also consistent with prior literature that forecasts changes in profitability (e.g., Fama and French 2000; Fairfield and Yohn 2001; Penman and Zhang 2002). We replace the level of asset turnover with the change in asset turnover (ΔATO_t), and retain ($ACCRUALS_{t-1}$, ($ACCRUALS_t$, $\Delta SALES_t$, and $NEG\_\Delta SALES_t$.

Unexpected core earnings and unexpected change in core earnings are the differences between reported and predicted core earnings and change in core earnings, respectively. The predicted values are calculated using the coefficients from models (I) and (II) above, estimated by fiscal year and industry and excluding firm I. Tables II and III provide descriptive statistics for these residuals. Referring to Table III, core earnings and unexpected core earnings are negatively correlated (-0.591). This negative association potentially confounds many studies of earnings management because both partitions (i.e., discretionary and nondiscretionary) are expected to be correlated in the same direction with the variable of interest (e.g., McNichols and Wilson 1988; Dechow et al. 1995; McNichols 2000). However, it is important to note that special items are positively

correlated with core earnings, while H1 posits a negative relation between special items and unexpected core earnings.

III. Test Design and Results

A. Main Analysis

Hypothesis 1 predicts that managers shift core expenses to special items (''classification shift''). As discussed in Section IV, if managers classification shift, then unexpected core earnings in year t is expected to be increasing with special items in year t, and the unexpected change in core earnings in year t + 1 is expected to be decreasing with special items in year t. To test H_2, I estimate the following regressions:

$$UE\_CE_t \quad = \alpha_0 + \alpha_1 \% SI_t + \varepsilon_t \tag{3}$$

$$UE\_\Delta CE_{t+1} = \eta_0 + \eta_1 \% SI_t + \nu_{t+1} \tag{4}$$

Definition:

UE_CE_t = *Unexpected Core Earnings* is the difference between *reported* and *predicted Core Earnings*, where the *predicted value* is calculated using the coefficients from model (I).

UE_CE_{t+1} = *Unexpected Change in Core Earnings* is the difference between *reported* and *predicted Change in Core Earnings*, where the *predicted value* is calculated using the coefficients from model (II).

$\% SI_t$ = *Income-Decreasing Special Items* as a *Percentage of Sales*, calculated as [*Special Items$_t$ x-1]/Sales$_t$*, when *Special Items* are income-decreasing, and 0 otherwise.

ε_t = *Error*

β = *Intercept*

Where UE_CE_t is unexpected core earnings in year t, and UE_CE_{t+1} is unexpected change in core earnings in year t + 1, the difference between reported and predicted core earnings and change in core earnings, respectively, where the predicted values are calculated using the coefficients from models (I) and (II) above, estimated by fiscal year and industry and excluding firm I. The variable $\% SI_t$ is defined as income-decreasing special items scaled by sales, both in year t. Note that a positive special item corresponds to an income decreasing special item (income-increasing special items are set to zero); I therefore predict α_1 to be positive and η_1 to be negative. Recall that many other variables were used in the generation of unexpected core earnings, my dependent variable. As such, I do not add additional control variables to Equations (3) and (4).

The Influence of Special Items to Core Earnings
in Earnings Management at Manufacturing Companies
Listed in Jakarta Stock Exchange

(Fajar Vishnu Pratama and
Rahmawati)

B. Results

Table III indicates that for the model I and model II, $F_{Statistic}$ to be obtained each of 13,97362 and 4,531706, while F_{Table} each of 2,21 (5%, (6-1), (6(44-1)) and 2,10 (5%, (7-1), (7(44-1)). Hence can be known that $F_{Statistic}$ > F_{Table} so that can be concluded that H_1 accepted.

Table III
Results of regression analysis

Independent variable	Dependent Variable	Coefficient	Statistic	Probability
C	CE_t	4,772981	38.50644	0,0000***
CE_{t-1}	CE_t	3,54	8,156958	0,0000***
ATO_t	CE_t	0,025660	0,282616	0,7777
$ACCRUALS_{t-1}$	CE_t	0,192358	1,118731	0,2643
$ACCRUALS_t$	CE_t	-0,066565	-0,254984	0,7989
$\Delta SALES_t$	CE_t	0,069649	1,404746	0,1614
$NEG\_\Delta SALES_t$	CE_t	2,975285	2,975285	0,0032***
Adj R-*Squared*: 0,235284				
F-statistic: 13,97362				
Prob(F-statistic): 0,000000				
C				
CE_{t-1}	ΔCE_t	4,412947	55.76861	0,0000***
ΔCE_t	ΔCE_t	1,13	1,916609	0,0571*
ΔATO_t	ΔCE_t	5,14	2,507390	0,0132**
$ACCRUALS_{t-1}$	ΔCE_t	0,569739	1,912727	0,0576*
$ACCRUALS_t$	ΔCE_t	0,015844	0,222169	0,8245
$\Delta SALES_t$	ΔCE_t	0,261757	0,813362	0,4172
$NEG\_\Delta SALES_t$	ΔCE_t	0,094407	1,639363	0,1031
Adj R-*Squared*: 0,130997	ΔCE_t	0,911265	1,639363	0,1031
F-statistic: 4,531706				
Prob(F-statistic): 0,000125				
C				
$\% SI_t$				
Adj R-*Squared*: 0.148076	UE_CE_t	1,91	11.29081	0,0000***
F-statistic: 36.28404	UE_CE_t	-9.997746	-6.023624	0,0000***
Prob(F-statistic): 0,000000				
C				
$\% SI_t$				
Adj R-*Squared*: 0.169124				
F-statistic: 52.09074	UE_CE_{t+1}	1,4	11.00357	0,0000***
Prob(F-statistic): 0,000000	UE_CE_{t+1}	-0,196270	-7.217392	0,0000***

*** Signifikan at 0,01
** Signifikan at 0,05
* Signifikan at 0,1

Besides, obtained that probability from $F_{Statistic}$ for the model I and model II each of 0,000000 and 0,000125. Hence by comparing between probability of $F_{Statistic}$ with the level of $\alpha = 5\%$ can be known that probability of $F_{Statistic} < \alpha$ (0, 05), so that can be concluded that H_1 accepted.

Table III indicates that for the model (I) independent variable ATO_t, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$ with dependent variable do not significant. Tables IV also indicate that independent variable CE_{t-1} and $NEG\_\Delta SALES_t$ with dependent variable significant. By together independent variable CE_{t-1}, ATO_t, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$, $NEG\_\Delta SALES_t$ with dependent variable CE_t with probability 0,000000.

Table III indicates that for the model (II) independent variable, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$, and, $NEG\_\Delta SALES_t$ with dependent variable ΔCE_t do not significant. Tables IV also indicate that independent variable, CE_{t-1}, ΔCE_{t-1}, and ΔATO_t with dependent variable ΔCE_t significant. By together independent variable CE_{t-1}, ΔCE_{t-1}, ΔATO_t, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$, $NEG\_\Delta SALES_t$, with dependent variable ΔCE_t significant with probability 0,000125.

Because the goodness of model I and model II independent variables by together significant to its dependent variable, hence can be concluded that H_1 accepted, meaning that managers classify core expenses as special items.

Table III indicates that for the model (III) independent variable $\%SI$ with dependent variable UE_CE_t significant. Tables IV also indicate that for the model (IV) independent variable $\%SI_t$ with dependent variable UE_CE_{t+1} significant. Because goodness model III and also model IV independent variable significant to its dependent variable, hence can be concluded that H_2 accepted, meaning that special items have influence to core earnings.

Table III also indicate that for the model III and model IV, $F_{Statistic}$ to be obtained each of 36, 28404 and 52, 09074, while F_{Table} equal to 4, 08 (5%, 1, (1(44-1)). Hence can be known that $F_{Statistic} > F_{Table}$ so that can be concluded that H_2 accepted.

Besides, obtained that probability from $F_{Statistic}$ for the model III and model IV is equal to 0,000000. Hence by comparing between probability of $F_{Statistic}$ with the level of $\alpha = 5\%$ can be known that probability of $F_{Statistic} < \alpha$ (0, 05), so that can be concluded that H_2 accepted.

The accuracy examination of estimate in a model can be seen from its determinant coefficient value. Better condition shown with R Square value (R^2), representing determinant coefficient value equation of examinee, higher level (Rahmawati, 2006). It's meaning in model with R Square (R^2) value, higher level can more predict the value of dependent variable variation.

The calculation of model regression 1 resulting R^2 value equal to 0,253419 meaning that 25,34% dependent variable CE_t can be explained by independent variable, CE_{t-1}, ATO_t, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$, and $NEG\_\Delta SALES_t$. While the rest equal to 74,66% explained by other factor outside regression model. Assess obtained depict R^2 that correlation between dependent variable CE_t with other variable that is, CE_{t-1}, ATO_t, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$, and $NEG\_\Delta SALES_t$ enough weaken because the value less than 0,5 (Santoso, 2000).

The calculation of model regression 2 resulting R^2 value equal to 0,168088 meaning that 16,81% dependent variable ΔCE_t can be explained by independent variable, CE_{t-1},

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

ΔCE_{t-1}, ATO_t, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$, and $NEG\_\Delta SALES_t$. While the rest equal to 83,19% explained by other factor outside regression model. Assess obtained R^2 depict that correlation between dependent variable ΔCE_t with other variable that is, CE_{t-1}, ΔCE_{t-1}, ATO_t, $ACCRUALS_{t-1}$, $ACCRUALS_t$, $\Delta SALES_t$, and $NEG\_\Delta SALES_t$ is enough weaken because the value less than 0,5 (Santoso, 2000).

The calculation of model regression 3 resulting R^2 value equal to 0,152272 meaning that 15,23% dependent variable UE_CE_t can be explained by independent variable $\%SI_t$. While the rest equal to 84,77% explained by other factor outside regression model. Assess obtained R^2 depict that correlation between dependent variable UE_CE_t with other variable that is $\%SI_t$, is enough weaken because the value less than 0,5 (Santoso, 2000).

The calculation of model regression 4 resulting R^2 value equal to 0,172434 meaning that 17,24% dependent variable UE_CE_{t+1} can be explained by independent variable $\%SI_t$. While the rest equal to 82,76% explained by other factor outside regression model. Assess obtained R^2 depict that correlation between dependent variable UE_CE_{t+1} with other variable that is $\%SI_t$, is enough weaken because the value less than 0,5 (Santoso, 2000).

V. Conclusion

This paper examines the classification of items within the income statement as an earnings management tool. Unlike accrual management or the manipulation of real activities, classification shifting does not change bottom-line earnings and, thus, does not reverse in future periods or invite the same level of scrutiny by auditors and regulators. However, individual line items have different information content for future earnings and, correspondingly, for investors.

We examine classification shifting between core expenses (cost of goods sold and selling, general, and administrative expenses) and special items. Using a model of core earnings, analogous to that of the accrual model, I find that unexpected core earnings are increasing in special items in the year of the special item, and this unexpectedly high performance reverses in the following year.

Target of this research is to get empiric evidence proving that managers classify core expenses as special items and prove that special items have influence to core earnings. Research is done during period perception in year 1999-2005, amount of used sample in this research counted 44 manufacturing business which enlist in Jakarta Stock Exchange and Indonesian Capital Market Directory (ICMD).

Overall, the evidence of classification shifting is compelling: (1) unexpected core earnings are increasing with special items in year t, but this improvement reverses in the following period; (2) the unexpected improvement only reverses if there are no special items present in year t + 1, otherwise managers appear to classification shift again in year t + 1, thereby maintaining the inflated core earnings; (3) the mean of CE_t (Core Earnings) in descriptive statistic at positive valuable manufacturing business of this matter indicate that at period 1999-2005 manufacturing business in Indonesia conduct action profit management by maximizing its core earnings; (4) From result of regression analysis above known that $F_{Statistic} > F_{Table}$ and probability of $F_{Statistic} < \alpha$ (0,05), so that can be concluded that H_1 and H_1 accepted; (5) low value of R^2 depict that correlation between dependent variable and independent variable enough weaken.

REFERENCES

Afrizal and Beidleman, 1973, Income Smoothing: The Role of Management. *The Accounting Review* (*October*): 653–667.

Ashari, Nasuhiyah., Hian C. K., Soh L. T., and W. H. Wong, 1994, Factors Affecting Income Smoothing Among Listed Companies in Singapore. *Accounting Business Research.* Vol.24 No.96 p.291.

Ayres, F. Lucas, 1994, Perception of Earnings Quality: What Managers Need to Know. Management Accounting. P.27–29.

Baber, W., Fairfield, P., and J. Haggard, 1991, The effect of concern about reported income on discretionary spending decisions: The case of research and development. *The Accounting Review 66* (*4*): 818–829.

Bagnoli and Watts, 1978, Towards a Positive Theory of the Determination of Accounting Standards. *The Accounting Review 53* (*Januari*): 112–134.

Biman, Stanly, 1982, Agency Research in Management Accounting: A Survey. *Journal of Accounting Literature*. p. 159.

Bamber, Bhattacharya., Sunder Kang., and K. R. Kumar, 1998, Accountings Earnings and Executive Compensation: The Role of Earnings Persistence. *Journal of Accounting and Economics*. p. 1–13.

Bartov, E., Givoly, D., and C. Hayn, 2002, The reward to meeting or beating earnings expectations. *Journal of Accounting and Economics 33* (*2*): 173–204.

Belkaoui, A. R, 1993, Accounting Theory. Edisi 3. Cambridge: The University Press.

Black, L. Ervin., Keith, F. Dellers., and T. S. Manly, 1998, Earnings Management Using Asset Sales An International Study of Countries allowing noncurrent asset revaluation. *Journal of Business Finance and Accounting 25* Nov–Dec: 1287– 1317.

Bruns and Merchant, 1990, The Ethics of Managing Earnings: An Empirical Investigation. *Journal of Accounting and Public Policy*. p. 79–94.

Bushee, B, 1998, The influence of institutional investors on myopic R&D investment behavior. *The Accounting Review 73* (*3*): 305–333.

Bushman, Robert., Raffi Indjejikian., and A. Smith, 1996, CEO Compensation: The Role of Individual Performance Evaluation. *Journal of Accounting and Economics*. p. 161–193.

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

Coase, R. J, 1937, The Nature of Firm. Economica. Vol. 4. p. 386–405.

Copeland, Ronald., and L. Liscastro, 1998, Income Smoothing. *Journal Accounting Research. Supplement*. p. 101–115.

Daley, Lane., and Philip Vigeland, 1993, The Effects of Debts Covenants and Political Costs on The Choice of Accounting Method: The Case of Accounting for R&D Costs. *Journal of Accounting and Economics*. p. 195–211.

Dechow, P., and R. Sloan, 1991, Executive incentives and the horizon problem: An empirical investigation. *Journal of Accounting and Economics 14 (1)*: 51–89.

Dye, R, 1988, Earnings Management in An overlapping Generations Model. *Journal of Accounting Research*: 195–235.

Fama, E. F, 1980, Agency Problems and The Theory of Firms. *Journal of Political Economy*. Vol. 2. p. 288–307.

Fischer, Marily., and K. Rosenzweig, 1995, Attitude of Students and Accounting Practitioners Concerning the Ethical Acceptability of Earnings Management. *Journal of Business Ethics*. Vol. 14. p. 433–444.

Frankel, M., and R. Trezervant, 1994, The Year End LIFO Inventory Purchasing Decision: An Empirical Test. *Accounting Review (April)*: 382–398.

Gujarati, D. N, 2003, *Basics Econometrics: Third Edition.* USA: McGraw-Hill International Edition.

Healy, P, 1985, The Effect of of Bonus Schemes on Accounting Decisions. *Journal of Accounting and Economics*, 7:85–107.

_____, And Krishna G. Palepu, 1990, Effectiveness of Accounting–Based Dividend Covenants. *Journal of Accounting and Economics*, 12: 97–124.

_____, And James M. Wahlen, 1998, A Review of The Earnings Management Literature and Its Implications for Standard Setting. *Working Paper*.

Jensen, Michael C., and W.H. Meckling, 1976, Theory of The Firm: Managerial Behavior Agency Cost and Ownership Structure. *Journal of Financial Economics 3*. hal. 305-360.

Jones, Jenifer J, 1991, Earnings Management During Import Relief Investigations. *Journal of Accounting Research*, 29: 193–228.

Mc Nicols, 2000, Research Design Issues in Earnings Management Studies, *Journal of Accounting and Public Policy*, 19: 313–345.

Mc Nichols, M., And G. P. Wilson, 1988, Evidence of Earnings Management from The Provision for Bad Debt. *Journal of Accounting Research*. Supplement: 1–31.

Mc Vay, 2005, Earning Management Using Classification Shifting: An Examination of Core Earnings and Special Items. *The Accounting Review*. Vol. 81 No. 3. pp. 501–531.

Mulford, Charles., and Eugene Comiskey, 2002, The Financial Numbers Game Detecting Creative Accounting Theory. New York: John Wiley and Sons, Inc.

Santoso, Singgih, 2000, *Buku Latihan SPSS Statistik Parametrik.* Jakarta: PT Elex Media Komputindo Gramedia.

Schipper, K, 1989, Commentary on Earnings Management. *Accounting Horizons*, December: 90–102.

Schipper, Khaterine., and L. Vincent, 2003, Earnings Quality. *Accounting Horizons*, Vol.17. Supplement, p.97-110.

Scott, Wilson, 1997, Some Economic Determinants of Time Series Properties of Earnings. *Journal of Accounting and Economics*, p. 31–48.

Scott, William R, 2003, *Financial Accounting Theory*. Third Edition. Prentice Hall.

Setiawati dan A. Na'im, 2001, Bank Health Evaluation by Bank Indonesia and Earnings Management in Banking Industry. *Gadjah Mada International Journal of Business*. May: 159–176.

Sweeney, A. P, 1994, Debt–Covenant Violation and Manager's Accounting Responses. *Journal of Accounting and Economics*, Mei: 281–308.

Utama, Sidarta and W. Cready, 1997, Institutional Ownership, Differential Predisclusure Precision and Trading Volume at Announcement Dates. *Journal of Accounting and Economics*. p. 129–150.

Watts, Rose L. and J. L. Zimmerman, 1978, Toward a Positive Theory of the Determination of Accounting Standards. *Accounting Review*. p. 112–134.

_____. 1986. *Positive Accounting Theory*. Prentice Hall.

The Influence of Special Items to Core Earnings   (Fajar Vishnu Pratama and
in Earnings Management at Manufacturing Companies   Rahmawati)
Listed in Jakarta Stock Exchange

This page is intentionally left blank.