Quest Journals
Journal of Research in Humanities and Social Science
Volume 13 ~ Issue 1 (2025) pp: 217-221
ISSN(Online):2321-9467
www.questjournals.org

Research Paper

Earnings Management: In What Way Is It Good and Bad?

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ABSTRACT: *The flexibility of companies in determining accounting methods and policies can be misused to achieve maximum profits and is often called creative accounting. Creative accounting techniques can be done with four patterns of earnings management. This study aims to examine a case of earnings management from one of the companies in Indonesia, PT X. This research uses a qualitative approach, namely a case study. The analysis traces earnings management practices, analyzes problems, and solves problems based on the philosophy of science, literature, and applicable accounting standards. The results of this study conclude that the earnings management pattern carried out by PT X is the income maximation pattern, which maximizes the profit figure when the financial condition is declining. This behavior is explained based on power and knowledge relations. PT X recognizes contract revenue in a lump sum, thus violating applicable accounting standards. PT X should recognize revenue based on the allocation of revenue each year. This research contributes to company management and users of financial statements. Company management is allowed to carry out earnings management. It is said to be good when done according to standards, and material matters must be disclosed in the notes of the financial statements. Contrary to that, earnings management can be harmful when it misleads the public. Users of financial statements should be skeptical of the financial information they obtain.*

KEYWORDS: *Creative Accounting, Earnings Management, Philosophy of Science*

R*eceived 15 Jan., 2025;* ***R****evised 28 Jan., 2025;* ***A****ccepted 30 Jan., 2025 © The author(s) 2025.*
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I. INTRODUCTION

The Industrial Revolution has intensified competition between companies. Companies compete to achieve excellence and survive in the midst of a rapidly expanding economy. Individual creativity is increasing, and it is required to think cleverly in every matter, especially economic problems. This high creativity is needed in all fields, including accounting. One of the accounting sciences that is being talked about is creative accounting.

Creative accounting is one of the developments in accounting practices that are different from existing practices (Sulistiawan & Januarsi, 2011). Accounting is a discipline that provides flexibility to management as company managers. Flexibility in the selection of accounting methods can be adjusted to business practices. However, some parties often misuse this flexibility by finding and using existing loopholes for fraud and profit. Creative accounting triggers the emergence of accounting scandals due to earnings management.

One of the companies in Indonesia that has consistently reached the peak of its glory is experiencing financial problems and scandals. The financial problems are experienced by PT X, which has experienced losses in its financial statements in recent years. This shows that the company's performance has declined after years of being the ruler in its industry sector. After experiencing losses, in 2019, PT X published its financial statements for the 2018 financial year with a net profit exceeding USD 800 thousand or more than Rp 11 billion (assuming an exchange rate of Rp 14,000 per US dollar). This figure is odd because it is a very high jump compared to 2017 when the company suffered a loss of around USD 200 million. In addition, weakening economic conditions, such as the Rupiah exchange rate in 2018 to Rp 14,000 per USD and the instability of world oil prices, make the company's profit figures look absurd.

PT X's polemic began with the company's board of commissioners opposing the reporting of unreasonable net income. The board suspected that PT X's financial statements were not presented in accordance with the Statement of Financial Accounting Standards. The soaring 2018 net profit was due to the recognition of contract income with one of the partners, PT Y, for its unearned accounts payable of approximately USD 239 million.

This case is an indication of irregularities in PT X's accounting practices. This deviation is detrimental to users of financial information, including investors who buy PT X shares. This deviation involved the directors and management of the company because it was not only a matter of manipulating financial statements but also revealed other cases. This opportunistic action must benefit one party. Therefore, this research was conducted to analyze in depth the case that occurred at PT X, which allegedly involved the power of the directors and management of the company who were responsible for preparing the 2018 financial statements, including the auditors who examined the financial statements.

II. LITERATURE REVIEW

2.1 Creative Accounting

Creative accounting is an accounting practice that differs from commonly used accounting practices (Sulistiawan & Januarsi, 2011). The term creative accounting is commonly known to the public as earnings management. Creative accounting is a tool or technique in human behavior to achieve specific goals. However, the goal that becomes a problem is whether the goal is good or bad.

According to Amat and Gowthorpe (2004), creative accounting is the transformation of financial information using the choice of accounting methods, estimates, and practices allowed by accounting standards. This definition means that a person can develop his creativity in analyzing and interpreting something to gain benefits and profits as long as it does not violate existing rules.

Sulistiawan (2003) defines creative accounting as the activity of business entities that utilize accounting techniques and policies to obtain the desired results. The intended result is high profits. Company management tends to get maximum benefits or profits when presenting financial statements. As the company's manager, management has more information than other parties, namely investors and creditors, causing information asymmetry, which can trigger the emergence of moral hazard. An action is said to be good and ethical when the action does not have a detrimental impact on others. To reduce the information gap, company management can make disclosures in the financial statements presented in the notes of the financial statements. Company management must make this disclosure when there is a material change in accounting method that allows an increase in profit. However, the concern is that accounting standards between countries differ. Hence, accounting techniques and policies that are legal and ethical in one country are not necessarily correct if applied in another country.

Creative accounting is not new knowledge, it is just a collection of existing accounting techniques and policies. It is a person's creativity and motivation that develops creative accounting. For this reason, this knowledge is necessary as a controlling tool in preparing the company's financial statements to achieve its goals.

2.2 Creative Accounting Motivation

The motivation for creative accounting can be divided into psychological and opportunistic motivation. A company will be motivated to use accounting techniques and policies creatively when confident of the rewards for these actions. Psychological or cognitive factors are a view that states that human or individual behavior tends to be influenced by their environment. Information from outside or the environment will affect a person's brain work process. When there is a relationship between expectations and rewards, a person will be motivated to achieve the expected goals. In the case discussed in this study, PT X is motivated to achieve the goal of public recognition because, in 2017, the company suffered losses. To maintain the company's reputation and still get a good assessment by the public and investors, the company management chose to carry out earnings management.

Second, opportunistic motivation can arise due to differences in interests between agents and owners, which makes achieving goals between the two different. This relationship is explained in the agency theory of Jensen and Meckling (1976), where a working relationship exists between the authorizing party and the authorized party in a work contract. This is utilized by the authorized party, namely company management, whereas an agent or executor of company operations has more information and control over the company than the shareholders (principal). Information control or this information asymmetry motivates managers to act creatively to maximize personal benefits, namely high compensation.

2.3 Creative Accounting Techniques

Scott (2012) summarizes the four common patterns in earnings management practices: taking a bath, income minimization, income maximization, and income smoothing. First, the taking a bath pattern is carried out by adjusting the company's profit for the current year to be very high or low compared to the profit for the previous year or the following year. This pattern is usually used in companies that are in an unfavorable condition, so they have to report a loss in a very extreme amount so that the next period can report profits according to the target. Second, income minimization is done by making the current year's profit lower than the actual profit. This pattern is often done with tax and political motivations so that taxes paid are not high and do not become the center of attention, which will cause high political costs. The third is the income maximization pattern. The third pattern is done by making the current year's profit higher than the actual profit. This pattern is usually widely used by companies that will conduct an IPO to gain investors' trust. The last pattern is income smoothing. This pattern reduces profit fluctuations so that reported profit is relatively stable. Fluctuations reflect uncertainty, so the more volatile earnings are, the more risky the company is. The impact is on stock price fluctuations, which indicate a risky stock.

III. RESEARCH METHOD

This study is qualitative research with a case study approach. The case study raised in this research is a creative accounting case from one of the companies in Indonesia, PT X. Research data was collected through information obtained from electronic media and literature. The analysis was carried out by examining the phenomenon and practice of earnings management in PT X, then discussed based on the philosophy of science and its handling based on accounting standards and principles. In addition, this study also provides a perspective from the researcher's point of view in understanding earnings management practices, starting from how to detect earnings management, what users of financial statements and the public should do, and ending with concluding under what conditions earnings management is good and bad.

IV. DISCUSSION

4.1 The Phenomenon of Earnings Management Practices

Human opportunistic behavior dominates the phenomenon of earnings management practices. A recent case is the earnings manipulation carried out by PT X in the 2018 financial statements. The case began when PT X entered into a cooperation contract with one of the service provider companies, PT Y, at the end of 2018. The cooperation was worth approximately USD 239 million. This cooperation contract is like a lease transaction where PT X grants PT Y the right to use or manage assets. The problem occurred because PT X had recognized income from the contract agreement with PT Y as income for compensation for granting rights from PT X to PT Y in the 2018 financial statements. This cooperation follows the Financial Accounting Standards in PSAK 23 on revenue. The figure should not have been included in the 2018 financial statements because the contract period is 15 years, and PT X did not receive the contract money until the end of 2018.

The board of commissioners also believes that contract revenue recognition is entirely inconsistent with PSAK 23, especially paragraphs 28 and 29. Revenue from the use of the company's assets by other entities is recognized when it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be measured reliably. The recognition is based on the substance of the relevant agreement. Moreover, PT Y did not make any payments until the close of the 2018 financial year. Meanwhile, the Ministry of Finance and the Financial Services Authority consider the contract rental income. Nevertheless, both agreed to restate the 2018 financial statements. Behind the scandal involving the company's management, it turned out that it also attacked the KAP public accountants who audited PT X's financial statements because they were considered inappropriate in conducting audit work on the revenue recognition transaction and violated the Auditing Standards. The auditor also did not have sufficient audit evidence of PT X's unreasonable profit.

4.2 Problem Analysis and Solving

4.2.1. Problem Analysis Based on the Philosophy of Science

Philosophy is a science with no boundaries and is related to all life forms. It is a methodical, systematic, and coherent knowledge of all reality (Hamersma, 1981). Philosophy of science is a branch of philosophy that questions and examines all issues related to science (Dua & Keraf, 2001). Philosophy of science directs not only the discussion of science's methods but also the relationship between science and society.

One of the philosophers recognized for his phenomenal thinking and shaking the world with his scientific truths is philosopher Michel Foucault (Foucault & Rabinow, 1997). Foucault critically analyzes dismantling the relationship between power and knowledge with two approaches, namely archaeology (focusing on historical conditions) and genealogy (focusing on historical processes). Based on Foucault's philosophy, the party fully responsible for preparing financial statements is the management of PT X. As the company manager, management must have more information and knowledge than other parties, especially external parties. As the master of knowledge, company management can prepare financial statements with the flexibility to get more benefits for the company's achievements if it can achieve targets and better performance than previous performance. The strength of management power significantly affects all layers of the company. This shows that there is indeed a relationship between power and knowledge. Foucault tries to expose that there is indeed a relationship between knowledge and power in real life. Every reality, especially in a company where some are in power and under power, and those with more and less knowledge, will shape its discourse.

4.2.2. Problem Solving

According to the Financial Accounting Standards, the basic principle of income recognition is accrual-based, meaning that income can be recognized even though the company has not received it in full. This allows the company to practice earnings management by recognizing income all at once in one year to achieve a certain profit level, get a bonus, and produce good performance according to the public. Faced with this problem, the Ministry of Finance and other related parties, including the Financial Services Authority, ordered PT X to restate its 2018 annual financial statements along with a public expose that must be carried out because it has violated the rules regarding the Presentation and Disclosure of Financial Statements and the Statement of Financial Accounting Standards (PSAK). In addition, PT X is also subject to administrative sanctions in the form of fines for the company and members of its board of directors who authorized the 2018 annual report of PT X. In addition, this issue also concerns the Public Accounting Firm that conducted the audit process of PT X so that the KAP must also accept the consequences. KAP must make improvements to quality control policies and procedures for violations committed. This shows that the Indonesian government is firm in handling this accounting scandal to maintain public confidence in the industry.

4.3 Earnings Management Detection

Companies that illegally do creative accounting and are found guilty can be said to have committed an accounting scandal. Users of financial statements need a way to detect earnings management so as not to fall victim to aggressive accounting tricks or scandals that may occur. Earnings management detection steps can be done qualitatively and quantitatively.

Qualitative earnings management detection can be done by identifying the principal accounting policies used by a company. Then, assess the company's accounting flexibility, its flexibility, and how often it applies or changes its accounting policies. Third, assess the company's strategy and whether there are differences in the company's accounting policies with other companies' accounting policies. The next stage is to assess the quality of the company's disclosures and whether the information available is sufficient to understand the company's operating conditions. Finally, users must identify potential accounting problems. In this case, what needs to be suspected is the existence of unexplained accounting changes, especially when PT X's financial condition is bad. In addition, it is necessary to check whether excessive and unexplained profit-increasing transactions exist.

Quantitative earnings management detection can be done in two ways, namely through accounting policies and real activities. Detection through accounting policies focuses on explaining the earnings management detection models commonly used in research: the Jones Model, Modified Jones Model, Kasznik Model, and Performance-Matched Discretionary Accruals Model. Meanwhile, earnings management through real activities can be done by three methods, namely manipulating sales or increasing sales unreasonably, reducing discretionary spending, and excessive production.

4.4 What Must We Do?

This case study recommends some appropriate attitudes in dealing with creative accounting conditions that are allowed but vulnerable to abuse. First, users of financial statements, management, and auditors must have skepticism about the information presented in the financial statements company. Skepticism is aimed at company management as the person in charge of the financial statements and the company auditors responsible for the financial statement opinion. Users of financial statements do not have information related to company management and do not know whether management is honest in maintaining the reliability of financial statements, so users of financial statements are always required to be skeptical of all financial statement information so as not to get caught up in unreliable financial statement figures and become victims in it,

Second, the public should continuously improve their knowledge and skills to understand financial statements. This knowledge is helpful in the accuracy of decision-making based on this information. It is challenging to minimize all the risks of existing information. However, with knowledge, the decisions will be better than not understanding any information in the financial statements—at least someone who takes information and makes decisions based on something that is controlled and understood. Therefore, knowledge can help a person understand financial statements, receive credible and valid information, and make relevant decisions based on that information.

Third, detailed observation is a form of analysis that comes from financial statements and economic analysis, an analysis of an industry's prospects and challenges. In making decisions, it is also necessary to look at the averages of other industries that are uniform, whether their profits are rising or falling. This observation is one way to see if there is an imbalance or a big difference. If there is a discrepancy, it is necessary to suspect whether there are other material differentiating factors.

V. CONCLUSION

The PT X case study concludes that flexibility in preparing financial statements must still follow applicable Financial Accounting Standards. In this case, PT X carries out earnings management with an income maximization pattern where when its financial condition is not good, management increases the current year's profit so that it can look healthy and regain the trust of the public and investors who will invest. PT X's earnings management pattern looks odd to the board of commissioners and the public because the method PT X uses is inappropriate, making the 2018 profit figure unreliable. Contract revenue recognition cannot be done simultaneously because the work contract is up to 15 years ahead. Revenue should be recognized based on the allocation of revenue each year.

The behavior carried out by the management of PT X is based on the thoughts of philosopher Michel Foucault, who states that there is a relationship between knowledge and power that causes the actions of a particular group to make other groups, like in prison, achieve personal gain. This hurts earnings management. Earnings management has a bad connotation when things are covered up, which will mislead the public, investors, creditors, and other users of financial statements. However, earnings management can be good when done correctly and according to standards, and there must be clear disclosure in the notes to the financial statements. Therefore, users of financial statements should be skeptical, have knowledge, and conduct a more comprehensive analysis to understand financial statement information before making business decisions.

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