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EARNING MANAGEMENT, STOCK RETURN AND COMPANIES' MERGER AND ACQUISITION

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Abstract

The purpose of this study was to find out the practice earning management before merger and acquisition announcement. It also aimed to examine the differences of stock return before and after merger and acquisition announcement among companies that were listed on Indonesia stock exchange. The samples were 35 companies that did merger and acquisition and listed in Indonesia Stock Exchange (IDX) period 2004–2013. Then, the data analysis was performed by computer statistic program SPSS. These samples were selected by using purposive sampling method. Analysis hypothesis used Independent sample t-test and Wilcoxon sign ranks test. The result of independent sample t-test showed that the companies tended to do earning management before merger and acquisitions. While the result of Wilcoxon signed ranks test showed that there was no difference between stock return before and after merger and acquisition announcement.

Keywords*: acquisition, earning management, merger, stock return*

Acquisition and merger statement then became solution when the crisis happened. Merger and acquisition in Indonesia was then regulated in Act no. 40/2007 regarding limited liability companies. Act no 27/ 1998 regarding merger, consolidation, and acquisition. Act. No. 28 /1999 regarding merger, consolidation, bank acquisition, and related other regulation, BAPEPAM (Badan Pengawas Pasar Modal dan Lembaga Keuangan) Act no. IX.G.1 regarding merger and consolidation of go public company. According to PSAK no. 22/2007 acquisition is corporate restructuring between 2 or more companies, which means that the company that conducts acquisition has obligation to control all companies' operational activities and net asset by providing certain assets. There are some requirements in conducting merger and acquisition that have been set by BAPEPAM which are the company must collect financial statement for the last 3 years, submit the result of independent analysis about fairness of company's stock and fixed asset, able to describe methods and procedure for the conversion of shares, inform the settlement of obligation to the third parties, and complete the

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rights of shareholder who disagree with the merger and acquisition.

Merger is one of some strategic decisions as a way of developing and growing company's business in facing increasingly tight competition. Meanwhile, the acquisition is the union of several companies or one company taking over another company. In mergers and acquisitions, there is a condition that supports the action of earnings management and stock return. In this situation, the acquirer may do the mergers and acquisitions by paying shares while the management of acquirer is trying to increase earning value. The purpose is to show earning power to attract company targets to do acquisition as well as to increase company's stock price.

Earning management is management intervention in external financial reporting process in order to reach a certain earning level to benefit one's self or company's interest. The opportunity to achieve earning arises from accounting method that provides opportunities for management to record a particular fact in different ways and to involve subjectivity in preparing estimates. Saputro & Setiawati (2004) stated that issue of how capital market processes accounting information, especially earning and components, are important for the shareholders.

Some previous researchers have examined the practice of earning management prior to merger and acquisition announcement. Pertiwi (2012) found that there is a significant difference in accounting policies by the company in the practice of earnings management between income increasing accruals and income decreasing accruals of 3 years before mergers and acquisitions. Meanwhile, Meta (2010) proved that there is no earnings management practice measure prior to the merger and acquisitions made by increasing income accrual. Lestari (2011) also stated that there was no indication of earnings management before the acquisitions conducted by the acquirer with income increasing accruals.

Previous researchers have done research about stock return before and after merger and acquisition announcement. Yudyatmoko (2000) examined the effect of acquisitions on stock returns changes in 34 cases of acquisitions during the period of 1989-1995. The result showed a significant reaction in the stock returns before and after the acquisition. Meanwhile, Nilam (2008) stated that there is no difference of level on abnormal stock returns after and before the merger and acquisition. Wiriastari & Mahfud (2010) also stated that the research result shows that the effect of significant abnormal return is low. The study indicates that time limit of 20 days pre-announcement and 20 days post announcement was too close. Thus, there is information leakage before the merger and acquisition announcement.

Based on research results obtained, there are research gaps conducted by previous researchers. Synergy of company merger and acquisition is not immediately visible after the company's merger and acquisition, but it would be seen in a longer period. Moreover, before and after the announcement of mergers and acquisitions, previous results are not significant because majority of the period was short. In addition, there are indications that a company's manager tried to do earnings management in order to attract the company target to do mergers and acquisition. This research will be conducted by integrating several previous researches from Hutagalung (2002), Nilam (2008), Usadha (2009), Meta (2010), and Pertiwi (2012), to find out earning management practice before announcement of merger and acquisition. However, the researchers will extend the research period. Besides, this research also aims to compare the differences between stock returns on mergers and acquisitions before and after announcement date, while adding 2 years of time period before and after merger and acquisition.

HYPOTHESIS

Widyan+ ingdyah (2001) divided earnings management in 2 definitions. First, in the narrow sense, earnings management is the behavior of managers to "play" with the discretionary component of accruals to determine the amount earnings. Second, in a broader sense, earnings management is a manager's actions to improve (decrease) in income reported on a unit. Which is manager's responsibility without resulting in an increase (decrease) economic profitability of unit in long-term. Accounting researchers usually relates the terminology of earnings management with the behavior of managers or financial statement preparers because there is an estimation that they do the earnings management in order to gain something. As the effect, earnings management could lower the credibility of financial statement if it is used to make a decision. It is because earnings management is one of some form of financial statement manipulations. Earnings management is a management action in order to increase could be both their personal wealths and/or to increase the value of the firm.

Earnings management is an action taken by management to increase or decrease earnings companies reported from unit, which is a responsibility of manager, and it does not have a relationship with an increase or decline in profitability in the long term (Meta, 2010). The detection of earnings management could be performed both qualitatively and quantitatively. Qualitative detection of earnings management will be done directly by using the evidence obtained in the company while quantitative detection will focus on models of earnings management detection, which are widely used in empirical research. So far, only aggregate accrual-based models is accepted as the strongest and the most accurate models to identify earnings management because first, this empirical model is consistent with the accrual basis of accounting used in recording transactions. Accrual accounting model could raise components of account accrual that could be easily tricked because this account is derived from transaction with no receipts and cash payment. Second, aggregate accruals models use all components of financial report to detect financial manipulation.

Aggregate accruals-based model used Modified Jones Models and the model was developed by Dechow *et al*. (1995). Modified Jones Model is component of total accruals, which is separated into 2 categories, those are discretionary accruals and non-discretionary accruals. Discretionary accrual is total accruals components of derived from managerial manipulation by utilizing freedom and flexibility in determining estimated value on accounting method. Meanwhile, the non-discretionary is component of total accruals is obtained from accounting records by following accounting standards.

Detection of earnings management in this study uses the accrual value of company. According to Zang (2011) accrual itself is a component in the financial statements that is easy to be tricked based on management section for recording transactions and preparing financial statements. The reason for using accrual component is because it does not require any proof of physical cash so that the size of effort to trick accrual component should not be accompanied by cash received or issued by the company. The basis of accounting is accounting record in which the company is required to recognize the right and obligation regardless when cash will be accepted or issued, which should be based on the time of the transaction.

However, there is a fundamental weakness of accrual basic accounting that is the nature of accrual account which is easy to be modified, with or without violating accounting principles. From this case, the first step is to detect the existence of earnings management by issuing a cash component of

the model accounting firm to determine the amount of the accrual component earned the company during a specific period. Therefore, earning of accounting should be decreased by company's operating cash flow during the relevant period. Meanwhile investing and financing components are not deducted from earning of accounting. Second, because both of cash flow is not the result earned by operational companies during the period, but the result earned by non-operational activity of company.

Generally, earnings management is done by 3 patterns which are increasing income, decreasing income, and income smoothing. Income increasing is a company effort to arrange for profit period to be higher than real earnings. Meanwhile, decreasing income is action to reduce income for the period. Income smoothing is an effort to regulate company earning to make it stable over the period.

Meanwhile, stock return is gained or obtained by shareholders because of their investment. Gain or loss of a security is indicated in a particular period. The return consists of the income and the relative capital gain on an investment. Calculations of stock return consist of capital gain and dividend. Capital gain represents the differences between profit and loss obtained by investor. Thus, the company needs to inform investor whether price stock is relatively higher or lower compared to the previous period. Dividend is part of earning company shared on particular period depending on management decision. If company's prospect is better, stock price will increase. When the stock price increases, the stock return also increases. It is because stock return price is obtained from the differences between actual stock prices and previous stock price.

Stock return is appropriate proxy to measure the effect merger and acquisition announcement on market performance. It is consistent with the finding of previous studies stating that information can be determinant that affects investor in making investment. In the process of stock return there are price and trading activity, it is to find out whether or not the investor uses information about merger and acquisition announcement as the basis for their investment.

Motivations for Earnings Management

Earnings management practices were based on several reasons. According to Rahman *et al.* (2012), there are some motives in doing earnings management are as follows:

Taxation motivations

Due to the stringent regulations from the government about the calculation of taxable net income, company has less flexibility in applying earnings management for income taxation. However, there is a tendency for company to switch inventory methods to LIFO (Last in First Out) to face the rising prices because under LIFO, reported net income and calculated taxes will be lower. This reflects positively in the securities market, as investors are more likely to invest in firms with lowered taxes when market prices rise.

Changes of CEO motivation

CEOs engage in behaviour that maximizes their utility. The following are consistent with the bonus plan hypothesis, which stated a CEO of a poorly performing firm will use earnings management to avoid being fired while another CEO will use it to maximize his/her income prior to retirement, and a new CEO will manage earnings to increase his/her future income potential.

Bonus motivations

There is asymmetry information about financial company that affects management to arrange earning management to maximize their bonus.

Political motivations

To the extent that companies are politically visible, that is, they are often in the public eye or subject to governmental scrutiny, company will use earnings measurement to reduce reported net income. This will circumvent external bodies from forcing a politically visible company to lower its profitability.

Debt motivations

Besides doing business contracts with shareholders, debt motivation is beneficial for company that conducts expansion. Meanwhile, managers often make some business contracts with third parties such as getting loan from lenders.

Sales stock motivation

Many companies do this motivation to offer their stock for public or to obtain capital from investor and or to expand their business for the acquisition of other company. This way aims to maximize the performance of company and to attract attention of potential investor.

Merger and Acquisition

Business expansion is needed by a company to achieve efficiency and to gain optimal benefits. In addition, another way to gain profit is to do a merger. Merger itself was an incorporation of 2 or more companies into one entity and will result on one name of company remains in use. Meanwhile, other companies' name will disappear. The word 'merger' is derived from the Latin word "mergere" which means join together, united, in combination, and leads to loss of identity due to something. Even though term of merger and acquisition are used sometimes synonymy for each other, however they have slightly variation interpretation. Raquib *et al*. (2003) stated acquistion means the purchase of one firm by another and the merger means an agreement between the boards of directors of 2 companies to combine. Merger is defined as an incorporation of 2 or more companies, in which only one company can be survive as a legal entity while the other activities stop or disbanded.

While the word acquisition is to buy or obtain things or objects to add on something that has been previously owned. Acquisitions in business terminology are defined as the acquirement of ownership or control of shares or assets of a company by another company (Moin, 2003).

Merger and acquisition activity in general has an impact on firm performance measured by profitability ratios as well as the performance of stock return. The impact can be negative or positive, both in the short and long term. In addition, the effect can take place not only around the announcement of merger and acquisitions, but also in settlement.

Earning Management

Earning management is a management action in order to increase their personal wealth or to increase the value of the firm. Earnings management is an action taken by management to increase or decrease earnings companies that reported from unit, which is a responsibility of manager, and did not have a relationship by an increase or decline in profitability in the long term (Meta, 2010).

According to Usadha (2009) the results showed that there is earnings management measures prior to the implementation of mergers and acquisitions by increasing income accrual. They stated gaining empirical evidence whether companies conduct earnings management before the execution of merger and acquisition. The research also aims to investigate performance changes of acquiring companies before and after merger and acquisition period 2000 until 2001. Based on the explanation above, the hypothesis formulated is as follows:

H_1: there is earning management before merger and acquisition announcement

Stock Return

Agency theory has assumed that each individual is solely motivated by self- interest, which causes a conflict between principal and agent. Agent is motivated to maximize the contractual fee that accepted as fulfilling economic and psychological needs. In contrast, the principal is motivated to contract or to maximize the returns from resources to prosperity their self and also the desire of stockholder. In stock return there is connected with agency theory that is motivation. The main motivation of the investors to invest their money in one of a kind investment is to obtain the optimal return of investment.

According to Hutagalung (2002) the result showed that there is a significantly positive result on abnormal return obtained by companies before and after merger and acquisition. The research concluded that 47 companies that did merger and acquisition had differences in positive average of abnormal return. This research used 30 days sample of analysis (15 days before and 15 days after announcement). Based on the explanation above, the hypothesis formulated is as follows:

H_2: there is difference between stock return before and after merger and acquisition announcement

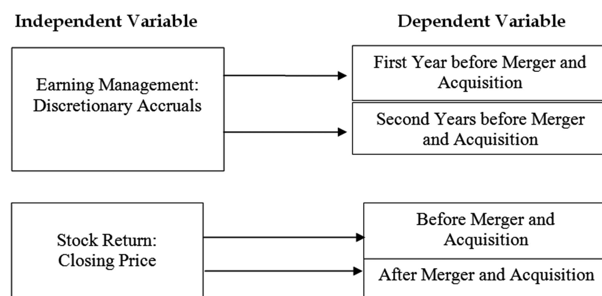

Figure 1. Research Model

METHOD

The population in this research are companies that listed on Indonesia Stock Exchange (IDX) in the period of 2004–2013 and had stock price listed on IDX, minimal 2 years before and 2 years after merger and acquisition announcement. The company also should report financial statement continuously during 2 years before merger and acquisition. This research uses purposive sampling as the data collection method. The criteria that are used by the researcher as follows: (1) merger and acquisition of companies listed in ISX from the period of 2004-2013; (2) the companies have the exact date of merger and acquisition; (3) the companies issue audited financial statement during 2 years before and after merger and acquisition with ended period on December 31st; (4) the companies issue daily stock price and close price during the estimation period; (5) the companies have completed the data regarding to variables that will be measured from the criteria above. Based on these criteria, the researcher found 35 companies that can be used as research sample, there are 5 companies doing merger and 30 companies doing acquisition.

Dependent variables in this research are before merger and acquisition announcement and after merger and acquisition announcement. Meanwhile, Independent variables in this research are earning management and stock return.

The first step in analyzing the data is to collect sample by following the required criterias. Then researchers will collect the data for research variables. Most of the collected data are raw material whereas researchers will input the raw data material into the formula to calculate each variable before they are ready to be analyzed.

The data for the first hypothesis are collected from financial statements issued by the companies, which are net income, cash flow operations, total assets, revenue, and account receivable and fixed assets of the company. These data determined for

variables earning management, first year before merger and acquisition, second years before merger and acquisition, a using the formula modified Jones models. These variables are used to search parameter values α_1, α_2, and α_3. The parameter values obtained from regression variables earning management, first year before merger and acquisition, second years before merger and acquisition, per year. However, if the differences values obtained between parameters are too far, then the regression performed on the converted value of data first year before merger and acquisition and second years before merger and acquisition will become standardized score or called z-score.

After determining the values of the parameters α_1, α_2, and α_3, then those values of the parameter are substituted to calculate Non-Discretionary Accrual (NDA) of each company. After NDA values have calculated, DA values can be determined and also the pattern of earnings management by the company.

To test the second hypothesis, annual closing prices for each company that available in ICMD are needed. The stock prices data that has been collected is aimed to determine the stock returns before and after mergers and acquisitions. After obtaining the data, researchers conduct a statistical data analysis method. The data will be processed by SPSS for Windows 16.0. Then, normality test is performed to make sure that the data are distributed normally. If the data are proved to be distributed normally, the data will be tested by using paired sample t-test. However if the data are not proved to be distributed normally, the data will be tested by using non-parametric test, which is called Wilcoxon signed rank test.

To prove whether the independent variable affect on the dependent variable, hypothesis testing is conducted. The hypothesis testing can be done by using 2 statistical tests, which are one sample t-test, paired sample t-test, or Wilcoxon test. The hypotheses are mentioned as follow:

H_1: there is earning management before merger and acquisition announcement

H_2: there is difference between stock return before and after merger and acquisition announcement

Criteria for testing the hypothesis by using probability test: (1) if probability value (ρ) is less than α (0.05), Ho is rejected; (2) if probability value (ρ) is more than α (0.05), Ho is accepted.

RESULTS

Earning Management

The descriptive statistic to show the total observation from companies conduct merger and acquisition in the period 2004-2013. The descriptive statistic can be seen in Table 1.

Table 1. The Descriptive Analysis for Earning Management

	N		Mean	Median	Std. Deviation	Minimum	Maximum
	Valid	Missing					
TAC/Ait-1	70	0	0.0203553	0.0085286	0.17589933	-0.27094	0.99472
(DREV - DREC)/ Ait-1	70	0	0.1168367	0.0513935	0.25114684	-0.92090	0.84439
PPE/Ait-1	70	0	0.3046458	0.2087976	0.30749725	0.00200	1.38268

As shown in Table 1, total observations on corporate merger and acquisition period 2004-2013 there are 35 sample companies. Based on the result of descriptive statistics, it can be concluded that the mean total accruals divided total assets is 2.0355%, the median is 0.0085286, and the standard deviation is 0.175899. The mean of revenue minus account receivable divided by total assets as much as 11.68% and fixed asset divided by total assets as much as 30.46%. The coefficient result of regression to find NDA as shown in Table 2.

From Table 2, shows the estimate value of NDA. After obtaining value of NDA are used to determine the value of DA, conducted by total accrual (TAC) minus NDA. Then, DA was used to prove companies conduct or does not conduct earning management practice in 2 years before merger and acquisition. The calculation of earning management 1 year and 2 years before merger and acquisition events as shown in Table 3.

Table 3 shows that the mean of earning management at 2 years before merger and acquisition is -0.0536, the value of negative discretionary accruals is seen in the minimum value of -0.31, the positive value of discretionary accruals is seen in the maximum value of 0.55, which means the value is low, and it shows that companies does not conduct earning management practice using income decreasing accruals. The table also shows that discretionary accruals have standard deviation of 0.17715, which means that the data are heterogenic or the value of sample and population is distributed randomly. Thus, it can be concluded that the sample has variation of data. It also shows the range between the minimum values of data is -0.31 and maximum data is 0.55, which is wider.

Meanwhile, the mean of earning management in the first year before merger and acquisition is 0.0584. The value of negative discretionary accruals is seen in the minimum value of -0.06 while the positive value of discretionary accruals is seen in the maximum value of 0.80. In addition, the standard deviation is 0.13823. The average of DA is positive, which means that companies conducted earning management using income increasing accruals in the first year before merger and acquisition.

Table 2. The Coefficient Result of regression Non-Discretionary Accruals

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.019	0.030		-0.638	0.526
	(DREV - DREC)/ Ait-1	-0.042	0.084	-0.060	-0.499	0.619
	PPE/Ait-1	0.145	0.069	0.254	2.109	0.039

Dependent Variable: TAC/Ait-1

Table 3. Descriptive Statistics of Earning Management

	N	Minimum	Maximum	Mean	Std. Deviation
DA (2) Two Years Before	35	-0.31	0.55	-0.0536	0.17715
DA (1) One Year Before	35	-0.06	0.80	0.0584	0.13823
Valid N (listwise)	35				

Stock Return

The results of descriptive analysis stock return as shown in Table 4.

The result of descriptive stock return shows that mean of stock return before merger and acquisition is 0.6111 and standard deviation as much as 1.54821. It means that stock market performance before merger and acquisition is still good enough and it has positive stock return. In addition, the mean of stock return after merger and acquisition is 0.2691 and standard deviation is 0.62063. It means that stock of companies' merger and acquisition has increasing an average as much as 26.91% each year

Hypothesis Testing

This hypothesis testing is aimed to know whether there is earning management before merger and acquisition or not. The indication of earning management is seen from a positive value on DA, where the company that has a positive DA which will show total accrual higher than the estimation. The first hypothesis is examined using one sample t test. The result of first hypothesis testing is presented in Table 5.

Table 5 shows that the mean value of DA in the first year before merger and acquisition is 0.05843 and statistically this value is greater than 0. The result of statistical test shows that at first year before merger and acquisition are indicative earning management because the probability value (sig-t) is 0.017 is less than 0.05, while in period t-2 (2 years before merger and acquisition) the mean of DA is -0.05356 and sigma as much as 0.083 > 0.05 which means there is no earning management practice on 2 years before merger and acquisition.

To measure second hypothesis will be analyzed by using normality test to make sure that the data are distributed normally. If the data are proved to be distributed normally then, the calculation will be tested by using paired sample t-test. But if the data are proved not to be distributed normally, researchers will conduct the non-parametric test by Wilcoxon signed rank test. Prior to conducting this test, first test is using normality test that is Kolmogorov Smirnov one sample test, as shown in Table 6.

Table 4. The Descriptive Analysis Stock Return

	N	Minimum	Maximum	Mean	Std. Deviation
Before stock return	35	-0.60	8.26	0.6111	1.54821
After stock return	35	-0.52	2.41	0.2691	0.62063
Valid N (listwise)	35				

Table 5. One Sample t Test for First Hypothesis

	T	Df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
DA 2 years before	-1.789	34	0.083	-0.05356	-0.1144	0.0073
DA 1 years before	2.501	34	0.017	0.05843	0.0109	0.1059

Table 6. Kolmogorov Smirnov Test for Second Hypothesis

		Before	After
N		35	35
Normal Parameters[a]	Mean	0.6111	0,2691
	Std, Deviation	1.54821	0,62063
Most Extreme Differences	Absolute	0.335	0,251
	Positive	0.335	0,251
	Negative	-0.269	-0,105
Kolmogorov-Smirnov Z		1,984	1.486
Asymp. Sig. (2-tailed)		0,001	0.024

a. Test distribution is Normal.

Normality test in Table 6 shows that asymptotic significance in the both period is 0.001 < 0.05 (before merger and acquisition) and 0.024 < 0.05 (after merger and acquisition), which means the result is less than 0.05 or 5 percent. Therefore, it can be concluded the distribution of data is not distributed normally. Considering data are not distributed normally, and then this second hypothesis will conduct the non-parametric test by Wilcoxon signed rank test as presented in Table 7.

Table 7. Wilcoxon Signed Rank Test for Second Hypothesis

Test Statistics[b]	
	Before Return - After Return
Z	-0.278[a]
Asymp. Sig. (2-tailed)	0.781

a. Based on positive ranks

b. Wilcoxon signed ranks test

DISCUSSIONS

The results of this study indicate that management tends to do positive earnings management before merger and acquisition. It is concluded that H_{a1} is accepted while H_{01} is rejected. Thus, there is earning management before merger and acquisition announcement. This research is consistent with Usadha (2009) which shows that there is earning management practice before merger and acquisition conducted by income increasing accruals. Companies made earning management by lowering the income in period t-2 (income decreasing accruals), and then earning management is performed by income increasing accruals in period t-1. It reasonably can be understood due to the stock market price problem. Every company that plans to do merger and acquisition needs a good performance of its financial statement by showing a good growth of its stock market price. It is possibly more either a stock market incentive or political cost motive (Rahman *et al.*, 2012).

According to Table 7, researchers found out that value of Wilcoxon Z is -0.278 and Sig as much as 0.781, the p-value (probability) is more than the significant level of 5% ($p > 0.05$). Which means that H_{02} accepted while H_{a2} is rejected whereas it shows the insignificant result and that the hypothesis cannot be proved. Hence, there is no difference between stock return before and after merger and acquisition announcement. This result was similar to Pertiwi (2012) research, who found that there was no difference between stock return before and after merger and acquisition. This result is expected because the spread of asymmetric information in the market will make the investor not able to take gain of the events merger and acqui-

sition. The result shows that there is no difference between 2 years before and 2 years after merger and acquisition, meaning that the periods to evaluate stock return 2 years before and 2 years after is not enough.

CONCLUSION AND SUGGESTION

Conclusion

This research aims to examine the phenomenon of earning management before and after merger and acquisition and their impact on stock return. Based on the result of data analysis, it can be concluded that there is earning management conducted using income increasing accruals before merger and acquisition. Earning management occurred on the period first year before merger and acquisition, and earning management did not occur on the period second years before merger and acquisition.

There is no difference between stock return before and after merger and acquisition announcement. It means that merger and acquisition events do not give a positive response and appeal for investors to buy some stocks in companies who conduct merger and acquisition, because the result shows that there is no difference in stock return 2 years before and 2 years after merger and acquisition.

Suggestion

This research has some limitation, such as mergers and acquisitions companies come from various types of industries such as manufacturing, banking, mining and other industries. Therefore, it cannot be compared representatively. The periods of observation which is 2 years before and after are too short to evaluate merger and acquisition on stock returns. This study only focuses on differences of stock return for merger and acquisition.

Some suggestions for the future research on this topic based on the limitation are first, it is better for next researcher to collect companies' data from only one sector. Thus, the research result can be compared and be more representative. Second, the next researcher should extend the research period. And third, the next researcher are expected to develop the research by comparing company's performance through financial ratio before and after merger and acquisition which is expected to find out the effect of earning management before merger and acquisition events towards company's performance after merger and acquisitions.

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