CHAPTER II

THEORITICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1 Definition Chief Executive Officer (CEO)

The CEO is the highest position executive manager in a corporation or organization. The CEO has some specific responsibilities depend on the need of the organization. The job description of a CEO varied by organization.

The CEO reports to the Board of Directors. However, in some non-profit settings, such as state government, the CEO may be the head of an agency or department and report to the office of the governor. The CEO may also own the business, and may have found the business, so his or her commitment to the business is significant.

Whether the chair person are president and CEO, or just CEO, he or she is the person in charge in giving command an organization. Beside he has specific responsibilities depending on the needs of the organization.

Thus, the CEO's responsibilities can vary from organization to organization. As with any level of management in an organization, the CEO's role starts with the fundamental job responsibilities of a manager.

Responsibilities of a CEO

The responsibilities of a CEO include:

1. Creating, communicating, and implementing the organization's vision, mission, and overall direction. Lead the development and implementation of the overall organization's strategy.
2. Leading, guiding, directing, and evaluating the work of other executive leaders including presidents, vice presidents, and directors, depending on the organization's reporting structure.
3. Soliciting advice and guidance, when appropriate, from a Board of Directors.
4. Formulating and implementing the strategic plan that guides the direction of the business or organization.
5. Overseeing the complete operation of an organization in accordance with the direction established in the strategic plans.
6. Evaluating the success of the organization.
7. Maintaining awareness of both the external and internal competitive landscape, opportunities for expansion, customers, markets, new industry developments and standards, and so forth.

2.2 Gender

Gender is a social variable to analyze the differences between boys and girls, adult male and female with regard to: roles, responsibilities and needs, opportunities and barriers (Haspels and Suriyasarn, 2005). Gender refers to distinctions and social relationships between girls and boys, adults male and female who learned and vary widely within and between cultures, as well as changed from time to time (Haspels and Suriyasarn, 2005).

Gender is an aspect of identity that is very meaningful, female and male have different experiences of formed the gender identity. Gender identity is formed around the age of three years. Boys and girls start to recognize behaviors and personality traits for each sex (Peek, 1981: 58)

Female and male have a difference psychologically where female are more emotional than male because female are more easily offended, easily influenced, highly sensitive, accentuates bubbling up of the feelings, and easy feeling. While male are not emotional, very objective, easily influenced, not easy separating the thoughts and feelings that are sometimes less sensitive and is able to nurture his feelings (Dagun, 1992: 4).

Harsiwi (2004) in Zanaria (2008) reveals that male tend to lack self-discipline in the work, so it needs to be applied a system of hard work discipline. Meanwhile, female tend to have higher self discipline than male, so the system of discipline that is applied more maintanance and maintain or improve the discipline.

2.3 Earnings Management

2.3.1 Earnings Management Definition

Managers have a strong interest in accounting policies choice. Given that managers can choose accounting policies from a set of policies, it is natural to expect that they will choose policies so as to maximize their own utility and or the market value of firm. Accoding to Scott (2009), earnings management is the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective.

Earnings management occurs when managers uses judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about underlying economic performance of the company or to influece contractual outcomes that depend on the reported accounting numbers (Healy and Wahlen 1999). Moreover, Gumanti (2000) said that earnings management performed by manager because they expect benefit from actions taken. Earnings management could give description about manager's behavior in order to report their business activities in certain period of time, which there is possibility of particular motivation which push managers to manage or set financial data reported. According to Setiawati and Na'im (2000), earnings management arise as a result of the use of accounting as an information and communication tool between company's internal and external corporate parties, so that it give rise to management to make policy.

2.3.2 Motivations for Earnings Management

According Scott (2003), motivations for earnings management is explained as follows:

1. Bonus Plan Purposes

   Profit is often used by company to measure management performance. Commonly, companies set the targeted profit to be achieved in the certain period, so managers are pushed to achieve the target. All other things being equal, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to current period. Firm managers, like everyone else, would like high remuneration. If their remuneration dpends, at least in part, on a bonus related to reported net income, then they may be able to increase their current bonus by reporting as high a net income as possible. One way to do this is to choose accounting policies that increase current reported earnings. Of course, because of the nature of accruals process, this will tend to lower future reported earnings and bonuses, other things equal. However, the present value of the manager's utility from his or her future bonus stream will be increased by shifting in towards the present.

2. Initial public offerings

   When company decides to go public, managers deal with earnings management in order to influence investor's decision. The use of accounting information and financial analysis to value the stock price could create incentive for managers to manage company earnings in order to influence stock price. When at IPO, prospectus is the only one source because besides prospectus, almost no other information available for investors. So, investors tend to rely on prospectus in order to get information and assess company will do IPO.

3. Stock price effect

   Managers conduct earnings management in order to affect the stock price traded on stock market. For example; managers provide a good and healthy financial statement, they provide a high profit with the aim to receive positive response form the market and expect company stock price will increase.

4. Political motivations

   Earnings management is conducted by managers in order to reduce political costs and government supervision. Those companies that perform earnings management with this motive tend to accounting method that will reduce the profit. Companies deal with it because they want to reduce public visibility in order to avoid highlighted by the public.

5. Taxation motivations

It is obvious if the higher profit gained by company, the higher tax will company paid to government. Setiadi (2009) stated that manufacturing company conduct income decreasing earnings management through dicretionary accruals as response to the change of oncome tax law in 2008. Managers try to minimize the profit in order to avoid high tax expense. There are various ways could be done by managers to manage companys' profit in order to minimize corporate tax. For example, company increases their percentage of bad debt expense in order to increased bad debt expense. If bad debt expense increase, it will reduce company' profit, this will make tax that must be paid to government will get smaller.

6. Contractual motivations

Debt contracts typically depend on accounting variables, arising from the moral hazard problem between manager and lender. To control this problem, long-term lending contracts typically contain covenants to protect against actions by managers that are against the lenders' best interest, such as excessive dividends, additional borrowing or letting working capital or shareholders' equity fall below specified levels, all of which dilute the security of existing lenders. All other things being equal, the closer a firm is to violation of accounting-based debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the current period. The reasoning is that increasing reported net income will reduce the probability of technical default. Most debt agreements contain covenants that the borrower must meet during term of the agreement. For example, a borrowing firm may covenant to maintain specified levels of debt-to-equity, interest coverage, working capital, and/or shareholders' equity. If such covenants are violated, the debt agreement may impose penalties, such as constarints on dividends or additional borrowing.

7. Changes of CEO

   Earnings management is done at the change of CEO. The old CEO will report a high rate of profit after in the prior period; they decrease company' profit, so the new CEO will face the difficulties in order to achieve the high rate of profit. The old CEO performs earnings management with the aim, in the next period they can be relected by the board of director

2.3.3 The Patterns of Earnings Management

According Scott (2009), patterns of earnings management that conducted by managers are as follows:

1. Taking a Bath

    Taking a bath is conducted by manager if company suffers a bad economic condition, and could not be avoided, recognized future expenses and total loss in the current period.

2. Income Minimization

    This earnings management pattern is conducted if company has a higher profit. In bonus plan case, managers that realize current profit approaching the 'cap' will conduct income minimization in order to maintain their bonus. Company that has high profit but does not want public or political attention could be conducted this pattern.

3. Income Maximization

    This earnings management pattern is conducted if company has a low profit. In bonus plan case, managers that realize curent profit approaching the 'bogey' will conduct income maximization in order to keep their bonus. In IPO case, managers could also conduct income maximization in company prospectus in order to increase company profit with the aim to give good impression to potential investors

4. Income Smoothing

    Income smoothing is conducted by managers in order to make company performance looks stable overtime it could give good signal to investors that will consider the company has good performance. Managers also could do income smoothing in order to keep company profit between bogey and cap with the aim to maintain their bonus.

2.3.4 Empirical Model of Earnings Management Management

Dechow et al. 9 (1995) have evaluated some models to detect and measure earnings management base on accrual. The models are:

1. **Healy Model**

Healy (1985) tests fro earnings management by comparing mean total accruals (scaled by lagged total assets) across the earnings management partitioning variable. Healy predicts that systematics earnings management occurs in every period.

Healy model for nondiscretionary accruals

$$\text{NDA}\tau = \frac{\sum TAit}{T}$$

Where :

NDA : estimated non-discretionary accruals:

TA_{it} : total accruals scaled by lagged total assets;

T : 1,2,...T is a year subscript for years included in the estimation period;

T :a year subsricpt indicating a year in the event period

2. The DeAngelo Model

DeAngelo model (1986) tests fro earnings management by computing first differences in total accruals, and by assuming that the first differences have an expected value of zero under the null hypothesis of no earnings management. This model uses last period's total accruals (scaled by lagged total asset) as the measure of nondiscretionary accruals. Thus the DeAngelo Model is :

$NDA_t = TA_{t-1}$

Where:

NDA : estimated non-discretionary accruals;

TA_{t-1} : total accruals scaled by lagged total assets

3. The Jones Model

Jones Model (1991) proposes a model that relaxes the assumption that nondiscretionary accruals are constant. This model attempts to control for the effect of changes in a firm's economic circumstances on discretionary accruals. The Jones Model for nondiscretionary accruals in the event year is :

$NDA_t = \alpha 1(1/A_t - 1) + \alpha 2(\Delta REV_t) + \alpha 3(PPE_t)$

Where

Ait-1 : Total Assets at t-1

ΔREV_t : Revenues in year t less revenues in year t-1 scaled by total assets at t-1

PPEit : Gross property plant and equipment in year t scaled by total assets at t-1

α1 α2 α3: Firm's parametrics parameters.

4. The Industry Model

Industry Model relaxes the assumption that nondiscretionary accruals are constant over time. However, instead of attempting to directly model the determinants of nondiscretionary accruals, the Industry Model assumes that variation in the determinants of nondiscretionary accruals is common across firms in the same industry. The industry model for nondiscretionary accruals is:

$$NDA_t = \gamma_{1+} \gamma_2 \, median_{\,t} \, (TA_t)$$

Where

Median t (TA): The median value of total accruals scaled by lagged asset for all non-sample firms in the same digit SIC code.

$\gamma_1 \gamma_2$: Firm's parametric parameters.

5. The Modified Jones Model

Modified Jones Model is designed to eliminate the conjectured tndency of Jones Model to measure discretionary accruals with error when discretion is exercised over revenues.

The change in revenues is adjusted for the change in receivables in the event period, because there is a credit sale in revenue on sales. Reduction on accounts receivable's value will show the net income (Dechow et al., 1995).

The model is :

a) $TA_{it} = N_{it} - CFO_{it}$

Where:

TA_{it} : Total accruals at **t** period

N_{it} : Net operating income, which is income before extraordinary items at **t** period

CFO_{it} : Cash flows from operating activity at t period

b) $TA_{it} / A_{it-1} = \alpha_1 (1/A_{it-1}) + \alpha_2(\Delta REV_{it} - \Delta REC_{it} / A_{it-1}) + \alpha_3 (PPE_{it}/A_{it-1}) + \varepsilon_{it}$

Where :

ε_{it} : Error term company at t period

α1 α2 α3 : Denote the ordinary least squares estimates of α1 α2 α3

TA : Total Accruals scaled by lagged total asset

Ait-1 : Total Asset at t-1

ΔREC_{it} : Receivables in year t less receivables in year t-1 scaled by total asset at t-1

ΔREV_{it} : Revenue in year t less receivables in year t-1 scaled by total asset at t-1

PPE_{it} : Gross property pant and equipment in year t scaled by total assets at t-1

Calculation for discretionary accrual in Modified Jones Model is formulated as follows:

$$NDA_{it} = \alpha_1 (1/A_{it-1}) + \alpha_2(\Delta REV_{it} - \Delta REC_{it} / A_{it-1}) + \alpha_3 (PPE_{it}/A_{it-1})$$

Empirically, the value of discretionary accrual can be positive or negative (Scott, 2009). If the discretionary accrual is positive, it means earnings management is performed with income increasing pattern. Negative discretionary accrual means earnings management has income decreasing pattern.

2.4. Positive Accounting Theory

Positive Accounting Theory (PAT) is a theory developed by Watts and Zimmerman in 1978, published through his writings in 1978 and 1979. The term " Positive" refers to a theory that attempts to make good predictions of real-world events. PAT tries to make good predictions of real world events and translate them to accounting transactions.

According to Scott (2003), PAT is concerned with predicting such actions as the choices of accounting policies by firm managers and how managers will respond to proposed new accounting standards. Positive Accounting Theory, as developed by Watts and Zimmerman (1986), is based onthe central economic-based assumption that all individuals' action is driven by self-interest and that individuals will always act in an opportunistic manner to the extent that the actions will increase their wealth. Given an assumption that self-interest drives all individual actions, Positive Accounting Theory predicts that organizations will seek to put in place mechanism that align the interest of the managers of the firm (the agents) with the interest of the owners of the firm (the principals).

The three hyphotheses of positive accounting theory are:

1. The bonus plan hypothesis

   All other things be equal, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to current period.

2. The debt covenant hypothesis

   All other things being equal, the closer a firm is to violation of accounting based debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the current period.

3. The political cost hypothesis

   All other things being equal, the greater the political costs faced by a firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods.

2.5.Statement of Financial Accounting Concepts No. 8

This Concept consists of two chapters which are Chapter 1: The Objective of General Purpose Financial Reporting and Chapter 3: Qualitative Characteristics of Useful Financial Information. This Concept which includes two chapters of that new conceptual framework, supersedes FASB Concepts Statements No. 1, Objectives of Financial Reporting by Business Enterprises, and No. 2, Qualitative Characteristics of Accounting Information.

1. Fundamental Qualitative Characteristics

   The fundamental qualitative characteristics of useful financial information are relevance and faithful representation. Both characteristics must be present for financial information to be useful.

   a. Relevance

   Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already aware of it from other sources.

   b. Faithful Representation

   Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only have to represent relevant phenomena, but it also have to be faithfully represent the phenomena purpose to represent. To be a perfectly faithful re presentation, a depiction would have three characteristic. It would be complete,neutral,and free from error. Of course, perfection is seldom, if ever, achievable. The Board’s objective is to maximize those qualities to the extent possible

c. **Steps to Apply the Fundamental Qualitative Characteristics**

The most efficient and effective process for applying the fundamental characteristics of useful financial information are :

1) Identify the phenomena that has the potential to be useful to the users of a reporting entity's financial information.
2) Identify the type of information about the phenomena that would be most relevant
3) Determine whether the information is available and can be faithfully represented.

2. Enhancing Qualitative Characteristics Comparability, verifiability, timeliness, and understandability enhance the usefulness of information that is relevant and faithfully represented. These characteristics can be used to determine how a phenomena should be depicted if two ways are equally relevant and faithfully

represented. The enhancing qualitative characteristics should be maximized

a. Comparability

   Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items

b. Verifiability

   Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depicti on is a faithful representation. Quantified information need not be a single point estimate to be verifiable.

c. Timeliness

   Timeliness means having information available to decision makers in time to be capable of influencing their decision. Generally, the older the information is, theless useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

d. Understandability

Classifying, characterizing, and presenting information clearly and concisely makes it understandable. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

2.6. Hypothesis Development

Earnings management is used by choosing the method of accounting by management as long as it does not deviate from the accounting standard. Earnings management could give description about manager's behavior in order to report their business activities in certain period of time, which there is possibility of particular motivation which push managers to manage or set financial data reported. Differences behavior of manager is always related to their attitude in performing an act.

Farrell and Hersch (2005), document that the gender diversity is associated with improved financial performance and higher firm value. Fondas and Sassalos (2000) presume that diverse boards are more effective than homogenous boards. They argue that women may improve decision-making by bringing different perspectives and opinions into a discussion.

Moreover, MacLeod and Heminway (2007) argues that women are more trustworthy than men, and thereby less likely to manipulate corporate financial and other disclosures. Klein (2002), Xie et al. (2003), and Ebrahim (2007) examine the relationship between earnings management and characteristic of the board of directors. Their results consistently indicate that earning management is negatively related to board of directors. Davidson et al. (2007) examine whether the age and career horizon of the firm's executives affect earnings management. Their findings suggest that firms with older CEOs, who are nearing the retirement age, are associated with aggressive income-increasing earnings management. Klein (2002), Xie et al.(2003) and Peasnell et al. (2001) found that independent directors are negatively affect to earnings management.

Gender differences in leadership styles, conservatism, risk averseness and decision making can give the affect for earnings management. Therefore, managerial characteristics are acknowledge as important determinants of earnings quality. Further, recent corporate finance literature indicates that the gender of the firm's executives and directors may affect corporate governance and the firm's financial performance. These findings suggest that executive gender may affect managerial behavior. The hyphothesis is :

H1: Gender has a negative affect on earnings management.