CHAPTER 1

INTRODUCTION

1.1. Background of the Problem

Earnings management currently is a central issue and has become a phenomenon that occurs in some amount of companies. Based on the capital market regulatory agency reports there are 25 cases of violation of capital markets that occurred during the year 2002 up to March 2003. From the 25 cases, there were 13 cases of violations related to conflict of interest and disclosure of information (Utami, 2005). Than that in 1998 up to 2001, there were many financial scandals in public companies with issues involving financial reporting issued.

Whereas according to the results of a comparative study conducted by Leuz in Purnomo and Pratiwi (2009) about earnings management and investor protection (observation period 1990 to 1999) showed that Indonesia is at the middle level in the order of 15 to 31 sample countries. When compared to other ASEAN countries equally were selected as a sample such as Malaysia, Philippines and Thailand, then Indonesia has the highest level of earnings management (Purnowo and Pratiwi, 2009).

Asymmetry between management (agent) with the owner (principal) provides the opportunities for managers to act opportunistically. In terms of financial reporting, managers can perform earnings management to mislead the owner (shareholder) of the company's economic performance.

Earnings manipulation practices in the capital market were not only occurred in Indonesia, but also other countries, such as Enron Corporation, World.com and Walt Disney Comp. For example, Enron Corporation has been proved conducted earnings manipulation which was conducted manipulation by agency auditors to increase profits approaching $ 1 billion, which actually never existed. As well as Xerox Corporation, company has been proved conducted accounting earnings manipulation through revenues with amount USD 6 billion. The number is not the same as the U.S. Securities and Exchange Commission estimated that the current value of 1997 to 2000 with amount USD 3 billion on that day. Again, some cases were occurred in Indonesia, such as PT. Lippo and PT. Kimia Farma were also related with financial reporting problem and both of them were suspected conducting manipulation (Gideon, 2005).

Therefore, we can see clearly when the financial statements of Lippo Bank on September 30, 2002 were published to the public on November 28, 2002. Management said that company's total assets and net profit with amount Rp 24 trillion and Rp 98 billion, prospectively. However, in financial statements from JSE (Jakarta Stock Exchange) on December 27, 2002, total assets decreased to Rp 22.8 trillion with a net loss of Rp 1.3 trillion. The differentiation in earnings due to the deterioration of the value, Management said there are repossessed assets of Rp 2,393 trillion in published reports to Rp 1.42 trillion in JSE report. As a result, there is a decrease in the overall balance of capital adequacy ratio (CAR) of 24.77 percent to 4.23 percent.

Some cases above showed that earnings manipulation practices in financial reporting are not a new thing. cruelty of the market and high competition, in turn has given rise to an impulse or pressure on securities firms to compete with the quality and good performance, no matter whether the means used are allowed or not. This is a challenge for prospective investors in assessing whether the content of the information contained role in the financial statements reflect the facts and the actual values or just the result of window dressing management.

Therefore, to detect earnings manipulation researcher used M-score (probability of manipulation). We posited that the M-score generated by the model will be informative of a company's returns. The reason is that the "profile of a typical earnings manipulator" as defined by Beneish (1999a) is a company that is (1) growing quickly (extremely high year-over-year sales growth), (2) experiencing deteriorating fundamentals (as evidenced by a decline in asset quality, eroding profit margins, and increasing leverage), and (3) adopting aggressive accounting practices (e.g., receivables growing much faster than sales, large income-inflating accruals, and decreasing depreciation expense) (Beneish, Lee, and Nichols, 2013).

However, the main focus of our study was return prediction, not fraud detection. Specifically, we investigated a potential link between the probability of manipulation (M-score) with stock return generated by the Beneish model. In Beneish 1999, the sample from 1993 until 2010 categorized not flagged as non-manipulation and flagged sign as manipulation. From the results, earnings manipulation could be detected by M-score model. Than in 2013, research was continued and from his table suggests that flagged companies (those that merely look like a manipulator) are associated with lower returns. From the result in Beneish 2013 also showed evidence that companies with a higher probability of manipulation (M-score) earned lower returns.

An information relevant to investors if the information is able to influence the decision of investors to trade in the stock market which is reflected in price changes. One of the information considered relevant by investors is the company's financial statements. If the capital market participants used financial statements as the relevant information in making investment decisions, financial statements should be announced on the public is able to affect the price of securities. In other words, the market reacted to the announcement of the financial statements. The reaction was indicated by a change in the price and trading volume of shares of the company. The financial statements as a result of the end of the accounting process is designed to provide prospective information needs of investors, creditors, and other external users for making investment decisions, and other determinations (Jogiyanto, 2005)

The result of earnings manipulation will impact to the lower quality of earnings. Here, the impact of lower quality of earnings will impact to market reaction; investor will make a decision to reduce stock demand. Then, the impact of lower stock demand will go to the lower stock price and decreasing company return as the impact. So, as the decision maker, investor needs to determine first their decision to invest or not to the company especially company which conducted earnings manipulation activities. Therefore, in this paper researcher want to research in the phenomenon of earnings manipulation in Indonesia with using M-score and the main focus of this study is stock return related with M-score as the model.

1.2. Formulation of the Problem

Based on the research background was described above, it can be identified the research problem wants to be investigated:

Does earnings manipulation in Indonesia using M-score has negative impact on stock return?

1.3. Objective of the Research

Based on the research question above, researcher has objective in conducting the research, which is:

To provide empirical evidence about relationship between earnings manipulation in Indonesia using M-score and stock return as an indicator that investors find earnings information to be useful and relevant.

1.4. Contribution of the Research

After researcher had conducted this research, researcher hoped the result of this research will contribute for:

1. Researcher

Give information to increase the knowledge of researcher about relationship between earnings manipulation in Indonesia using M-score and stock return.

2. Investor

Give additional information to investor related to stock return as a determination to making decisions in investment process based on financial report.

3. Companies

To reduce earnings manipulations by the company in disclose company financial report.

1.5. Data Analysis

In analyzing data in this research, researcher conducted through this below steps:

1. Calculate all eight variables in M-score model
2. Enter all of eight variables into this model and calculate M-score
3. Categorize as manipulator if the result of M-score Company is exceeded -1.78.
4. Calculate cumulative abnormal return with find actual return, expected return, and abnormal return.
5. Conduct normality test to make sure the data have normal distribution
6. Therefore, the next step is regression and hypothesis testing to test the alternative hypothesis is accepted or rejected.

1.6. Systematic Content

This research prepared into following systematic:

CHAPTER I: INTRODUCTION

Chapter I is the introduction part of this research which is consist of background, research problem, research objective, research contribution, and also the systematic of writing.

CHAPTER II: THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

Chapter II contains theoretical background for this study which discuss about earnings manipulation detection with m-score model, stock return, and the relation both of them. Furthermore, this chapter provides the conceptual framework for hypothesis development that is being proposed in this research.

CHAPTER III: RESEARCH METHODOLOGY

Chapter III consists of the scope of sample selection, data collection technique, variables description which includes independent variable, dependent variable, empirical model, and also data analysis method used in this study.

CHAPTER IV: DATA ANALYSIS AND DISCUSSION

Chapter IV contains the results of processing and data analysis, whether the result is able to meet and prove the proposed hypothesis or not. The results of several tests such as normality test and hypothesis test. Further discussion on the result of statistical analysis will be included as well.

CHAPTER V: CONCLUSION AND SUGGESTION

Chapter V consist the final conclusion to answer research questions, research limitation, and the suggestion for further research.