

## **CHAPTER II**

### **THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT**

#### **2.1. Financial Statements**

Financial Statements are a central feature of financial reporting. IAS 1 refers to financial statements as “a structured representation of the financial position and financial performance of an entity” and elaborates that the objective of financial statements is to provide information about an entity’s financial position, its financial performance, and its cash flow, which is then utilized by a wide spectrum of end users in making economic decisions. In addition, financial statements also show the results of management’s stewardship of the resources entrusted to it. A financial statement should present true and fair picture of the business entity. So, financial statements are prepared by accountant to give financial information in financial reporting.

Financial reporting provides information for two broad groups of users, which are internal users and external users. Internal users are individual or groups inside the company who has authority to plan, organize, run the business, and make decision (Weygandt et al., 2008). External users are individuals or groups outside the company

who want to know how the company runs its business from the information provided in the financial report. There are two common groups of external users, which are investors and creditors (Weygandt et al., 2008). In this research, Investors are those who use the information from financial report to make decision to buy, hold, or sell stock. If company conducted earnings manipulation through financial statements, it will impact on misleading of information in investor interest. So, financial statements should present fairly the financial position, financial performance, and cash flow an entity as components of financial statements.

### **2.1.1. Components of Financial Statements**

The components of financial statements according International Financial Reporting standards (IFRS) consist of:

1. A statement of financial position as at the reporting date (end of the reporting period).

The statement of financial position is a statement that presents an entity's assets, liabilities, and equity (net assets) at a given point in time. The statement of financial position is sometimes described as a "stock" statement because it reflects the balances of the company's accounts at a moment in time, as opposed to the other basic financial statements, which are described as "flow" statements all reflect summarized results of transactions over a period of time.

2. A statement of comprehensive income for the period.

The IASB's framework states that comprehensive income is the change in the entity's net assets over the course of the reporting period arising from nonowner sources. Comprehensive income comprises all components of "profit or loss" and of "other comprehensive income".

3. A statement of changes in equity for the reporting period.

Equity (owners', partners', or shareholders') represents the interest of the owners in the net assets of an entity and shows the cumulative net results of past transactions and other events affecting the entity since its inception. The statement of changes in equity reflects the increases and decreases in the net assets of an entity during the period. In accordance with IAS 1, all changes in equity from transactions with owners are to be presented separately from non-owner changes in equity.

4. A statement of cash flows for the reporting period.

The purpose of the statement of cash flows is to provide information about the operating cash receipts and cash payments of an entity during a period, as well as providing insight into its various investing and financing activities. It is a vitally important financial statement, because the ultimate concern of investors is the reporting entity's ability to generate cash flows which will support payments (typically but not necessarily in the form of dividends) to the shareholders. More specifically, the statement of cash flow should help investors and creditors assess

a. The ability to generate future positive cash flows

- b. The ability to meet obligations and pay dividends
  - c. Reasons for differences between profit or loss and cash receipts and payments
  - d. Both cash and noncash aspects of entities' investing and financing transactions
5. Notes of financial statement.

Information provided in addition to that presented in the financial statements, which comprise a summary of significant accounting policies and other explanatory information, including narrative descriptions or disaggregation of items presented in those statement as well as information about items that do not qualify for recognition in those statements.

6. A statement of financial position as at the beginning of the earliest comparative period when the reporting entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

### **2.1.2. Basic Assumption of Financial Statements**

An entity presenting financial statements in accordance with IFRS must include an explicit and unreserved statement of compliance with all the requirements of IFRS in the notes. There are two basic assumptions in accordance with IFRS:

- a. Going Concern

When preparing financial statements, management makes an assessment regarding the entity's ability to continue in operation for the foreseeable future (as a going concern). Financial statements should be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. If the result of the assessment cast significant doubt upon the entity's ability to continue as a going concern, management is required to disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern. When the financial statements are prepared on the going concern basis it is not necessary to disclose the basis.

#### b. Accrual Basis of Accounting

Financial statements, excepts for the statement of cash flow, are to be prepared using the accrual basis of accounting. Under the accrual basis of accounting, an entity recognizes the elements of financial statements (items such as assets, liabilities, income, and expenses) when they meet the definition and recognition criteria for those elements in the framework. Consequently, transactions and events are recognized when they occur and they are recorded in the accounting records and presented in the financial statement in the period when they are occurred (and not when cash is received or paid). For example, revenues are recognized when earned and expenses are recognized when incurred, without regard to the time of receipt or payment of cash.

## 2.2. Earnings and Accrual Basis

Indonesian Institute of Accountant (IAI) has its own understanding of Income. IAI does not translate in terms of profit but in terms of earnings. Income or earnings is defined as increase in economic benefits during accounting period in form of revenue or increase in assets or decrease in liabilities that result in equity increase which not come from capital contribution. Earnings or profit is important information in financial statement which has various uses in various contexts.

Earnings are the reason corporation exist, and are often the single most important determinant of stock's price. Earnings are important to investor because they give an indication of the company's expected future dividends and its potential for growth and capital appreciation. The other important of earnings, earnings as a basic to determine investment policy and taking a decision, measure performance of company, evaluation management performance, estimation of ability of a company to earn long-term earnings, predict future cash flow, and measure investment ratio and certain company credit.

Earnings measurement based on accrual basis which is different with cash basis. Accrual basis admits the impact of transactions on financial report in a certain period when revenues and expenses occurred. Therefore, revenue is recorded when it received and expenses is recorded when it occurred (Horngren, 1998). In

manipulation practices, the accountants or parties conducted these activities through financial statements and commonly those financial statements based on accrual basis.

Although earnings as well as we know as measurement of performance that is very useful, but the components accrual in them have trouble in valuation. Research Sloan (1996) shows that investors fail to correct the value of total accruals because investors overestimate the persistence of the accrual. The study suggests that abnormal accruals can be obtained through the acquisition of companies with low accruals and selling companies with high accruals. This phenomenon is then referred to accrual anomaly. Subrahmanyam (1996) show that how discretion of components accrual valued by investors. The results of these studies indicate that managers use discretion over accruals to smooth earnings (earnings management practices) and provide signal information to investors about the company's future performance, it shows that the observed rational market pricing.

### **2.3. Earnings Management and Agency Theory**

Scott (2003:369) defines earnings management as "the choice by a manager of accounting policies so as to Achieve some specific objectives" which means the choices made by managers in determining accounting policy to achieve some specific goal. The concept of earnings management using the approach of agency theory which states that "the practice of earnings management is influenced by a conflict

between the interests of management (agent) and the owner (principal) arising from each party trying to reach or consider the level of prosperity that pleases".

Agency theory has assumed that each individual is solely motivated by self-interest, giving rise to a conflict of interest between principal and agent. Principal parties entered into motivated to improve the life of his contract with the ever-increasing profitability. Agent is motivated to maximize the fulfillment of economic and psychological needs, among others, in terms of obtaining an investment, loan, or contract compensation. Conflict of interest is increasing mainly because the principal cannot monitor the activities of daily management to ensure that management is working in accordance with the wishes of the shareholders (owners).

In an agency relationship, the principal does not have enough information about the agent's performance. Agents have more information about their own capacity, work environment, and the company as a whole. This has resulted in an imbalance of information held by the principal and the agent. Imbalance of information is called the asymmetry of information. The assumption that individuals act to maximize his own, resulting in agent utilizes its information asymmetry to hide some information that was not known to the principal. Asymmetry of information and potential conflicts of interest between principal and agent encourages agents to provide information that is not true to the principal, especially if the information relates to the measurement of agent performance. One form of agent action is referred to earnings management.



### 2.3.1 Motivations of Earnings Management

According Scott (2011), motivations for earnings management is explained as follows:

#### 1. Bonus Plan Purposes

Profit is often used by company to measure management performance. Commonly, firms set the targeted profit to be achieved in the certain period, so that the managers are forced to achieve the target. All other are being equal, managers of the firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to current period. Managers, like everyone else, would like to have high remuneration. If their remuneration depends on a bonus related to the reported net income, then they tend to report the net income as high as possible, in order to get higher current bonus.

#### 2. Covenant Purposes

Earnings management for covenant purposes is predicted by debt covenant hypothesis of positive accounting theory. Because covenant violation can impose heavy costs, firm managers are expected to avoid them. They will also try to avoid being close to violation, because it will constrain their freedom of action in operating the firm. Therefore, earnings management appears as a device to reduce the profitability of covenants violation in debt contracts.

### 3. Implicit Contracting Purposes

The investigation of earnings management for implicit contracting purposes is done by Bowen, DuCharme, and shores (1995). It is said that implicit contracting purposes can be bolstered by high reported profits. This high of reported profits will increase stakeholders' confidence that the manager will continue to meet contractual obligations. Implicit contracting purposes arise from continuing relationship between the firm and its stakeholders and represent expected behavior based on past business dealings.

### 4. Investors Earnings Expectation

Investors' earnings expectation can be formed through several strategies. For example, the strategy may be based on earnings for the same period last year on recent analyst or company forecast. Firms which report earnings more than what is expected will enjoy a significant increase of share price as investors revise upwards their probabilities of good future performance. As a result, managers have a strong incentive to ensure that earnings expectations are met, particularly if they hold share-related compensation.

### 5. Companies' Reputation

To maintain companies' reputation, the managers have to be able to show to the investors that companies have a good performance. To do this, at least managers must be able to ensure that the companies meet investor's expectation and give the

financial statement on time without implausible explanation (Barton and Mercer, 2005)

## 6. Initial Public Offerings

In definition, firms which make initial public offerings do not have an established market price. This raises question of how to value the shares of such firms. The assumption that financial accounting information is included in the prospectus is a useful information source. There is an empirical evidence that the market responds positively to earnings forecasts as a signal of firm value (Clarkson, Dontoh, Richardson, and Sefcik, 1992). This raises the possibility that the managers of firms going public may manage the earnings reported in their prospectuses in order to receive higher price of their shares.

### **2.4. Earnings Manipulation**

Earnings Manipulation is the other side of earnings management. Firms' management may have a motive to give a misleading picture regarding the true financial position of a firm. They may attempt to influence reported income in order to increase their remuneration through accounting-number based bonus schemes, and to secure their position in the firm. Within this context managers may try to manipulate the reported earnings towards a particular direction. Earning's manipulation may negatively affects firm's value. The cases of Enron signify that

profits' manipulation can seriously damage investors' interests (Paltrow, 2002). Firm's managers can influence the reported figures of the firms by the selective application of particular reporting policies. One of the objectives of the corporate governance mechanisms is to restrain a possible tendency of the firm's management to influence reported accounting figures (Chalevas and Tzovas, 2010).

In other words, Earnings manipulation is *possible* while carrying out earnings management if the financial report preparers violate accounting statutes and guidelines.

#### **2.4.1. Techniques of Earnings Manipulation**

According to McGregor<sup>1</sup>, some of the techniques used to manage and manipulate earnings will be discussed below:

##### a. "Cookie-jar" Reserves

The accrual of expenses is to reflect the period in which the expense was incurred. For example, if a firm hires a consultant to perform a particular activity, it should reflect the expense related to that activity in the period in which it is incurred, not when the bill is paid or invoice received. In many cases, the accrual of expenses, or reserves in particular industries such as insurance and banking, are based on estimates. As such, the estimates have varying degrees of accuracy. During times of strong earnings, the firm establishes additional expense accruals and subsequently

<sup>1</sup>The source of these techniques above were taken by researcher in google based on Scott McGregor paper with title earnings management and earnings manipulation without year published

reduces the liability to generate earnings when needed in the future - pulling a "cookie from the jar".

b. Capitalization Practices - Intangible Assets, Software Capitalization, Research and Development

In 1997, companies were allowed to capitalize the costs of internally developed software and amortize it over the useful life, generally three to five years. Capitalization is to represent the development costs. The capitalization process of companies has the potential for manipulation because these assets are often intangible and based on judgment. A firm may allocate more expenses to a project that can be capitalized to reduce current operating expenses.

c. "Big bath" One-Time Charges

Unusual or non-recurring charges have become one-technique used by firms to escape the maze of over aggressive accounting practices. Many believe and anecdotal evidence has shown that analysts overlook non-recurring charges because they are not part of the firm's ongoing operations or operating income. Typical non-recurring charges include writing down assets, discontinuance of an operating division or product line and establishing restructuring reserves.

As discussed previously, firms practicing earnings management deplete the economic earnings from future periods. As their ability to sustain earnings growth diminishes,

they may seek an event that can be characterized as one-time event and "overload" the expenses attributable to that event. The one-time charge may be discounted by analysts as not being part of operating earnings while the stock price does not suffer the consequences normally associated with missing earnings targets. To provide itself with more "cookie jar" reserves or mask its past sins, the firm may take other write-offs or create other accruals not directly tied to the event and attribute those expenses to the one-time event.

A study by Elliot and Hanna (1996) reported that reports of large, one-time items increased dramatically between 1975 and 1994. In 1975, less than 5% of companies reported a large negative write-off compared to 21% in 1994. The authors also showed that companies that had previously reported similar write-offs were more likely to do so.

#### d. Operating Activities

Managers often have the ability to modify the timing of events such that the accounting system will record those activities in the period that is most advantageous to management. The activity does not alter the long-term economic value of the transaction, just the timing and thus, comparability of financial statements. For example, a company could accelerate its sales and delivery process such that it records sales in December that normally would have been reported in January. Thus, the company reports higher fourth quarter sales, revenue and profits. In the long-term,

the company would ultimately report the same sales and profits; however, it has inflated its growth in the near term, and reduced profits in the future period.

#### e. Merger and Acquisition Activities

One type of significant event that may be used to mask other charge-off is mergers and acquisitions. In most cases, there is some form of restructuring involved creating the need for a large one-time charge along with other merger-related expenses. The event provides the acquirer with the opportunity to establish accruals for restructuring the transaction, possibly attribute more expense than necessary for the transaction. The company may also identify certain expenses that are revalued on the seller's balance sheet, increasing goodwill. If the conservative valuations prove to be excessive, the company is able to reduce its operating expenses in the near term by reducing its estimate for the liability. The additional goodwill created would be amortized over a long period of time and not have a significant impact on near term results.

#### **2.4.2 Earnings Manipulation and Earnings management**

The differentiation between earnings manipulation and earnings management can be seen here through this below table.

**Table 1****Earnings Manipulation and Earnings Management**

Earnings Manipulation	Earnings Management
Earnings manipulation violates accounting statutes and guidelines.	Earnings management can be performed and still not violates accounting statutes and guidelines.
Commonly earnings manipulation is conducted by management Intentionally and unintentionally.	Commonly earnings management is conducted by management intentionally.

**2.5. Detection of Earnings Manipulation using M-Score**

M-score Model is a probabilistic model. This model was found by Messod D. Beneish in year 1992 in United State of America as the company samples and his paper was published in year 1999. As the first, Beneish tested using a sample of 74 firms that manipulate earnings. From his research, Beneish found that sample manipulators typically overstate earnings by recording fictitious, unearned, or uncertain revenue, recording fictitious inventory, or improperly capitalizing costs. Therefore, Beneish estimate model for detecting earnings manipulation from year 1982 until 1992 and the samples used all industry except financial institution in news



media search and total sample from his research is 2406 company samples. Based on his evaluation in year 1992, the model form “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). So, M-score to help to uncover companies who are likely to be manipulating their reported earnings. Companies with a higher score are more likely to be manipulators. M-score model is a probabilistic model and it will not detect manipulators with 100% accuracy.

This model features eight accounting-based variables, each of which is so constructed that higher values are associated with a greater probability of earnings manipulation. A description of the variables and the rationale for their inclusion are provided below:

#### 1. Days Sales in Receivables Index (DSRI):

DSRI is the ratio of daily sales in receivables in the first year in where earnings manipulation was found (in  $t$ ) of the appropriate size on year  $t - 1$ . This variable is a measure of whether the accounts receivable and revenue are in or out - of - balance in two successive years. A large increase in days sales in receivables could

be the result of a change in policy to spur sales credit in the face of increased competition, but the increase disproportionate relative sales in receivables may also indicate revenue inflation. Large increase in Daily sales in receivables that will be associated with the possibility higher incomes and profits those were excessive.

## 2. Gross Margin Index (GMI)

GMI is the ratio of gross margin in year  $t - 1$  to the gross margin in year  $t$ . GMI is greater than 1; indicate that the margin Gross profit has deteriorated. Lev and Thiagarajan (1993) showed that the decrease in gross profit margin is a negative signal about the prospects company. If firms with little prospect more likely to involved in the manipulation of earnings, there is a positive relationship between GMI and the possibility of earnings manipulation.

## 3. Asset Quality Index (AQI)

Quality assets in a given year is the ratio of non-current assets other than assets fixed property , plant and equipment ( PPE ) to total assets and measures the proportion of total assets that have benefits in the future potentially uncertain . AQI is the ratio of asset quality in year  $t$ , the relative quality of the assets in year  $t - 1$ . AQI is a measure aggregate of changes in asset risk analysis suggested realization by Siegel (1991). If AQI is greater than 1 indicates that potentially increasing the company's involvement in the suspension costs.

## 4. Sales Growth Index (SGI)

SGI is the ratio of sales in year  $t$  to sales in year  $t - 1$ . Growth does not mean manipulation, but the growth of the company regarded by professionals as more likely to commit fraudulent financial statements for the financial position and needs capital put pressure on managers to achieve earnings targets (National Commission on Fraudulent Financial Reporting (1987), National Association of Certified Fraud Examiners (1993)). In addition, concerns about control and reporting tend to be slower than operating in the high growth period (National Commission Reporting Financial Fraud (1987), Loebeckke et al. (1989)).

#### 5. Depreciation Index (Depi):

Depi is the ratio of the rate of depreciation in year  $t - 1$  compared with level corresponding to the level of depreciation of year  $t$ . In particular equal to the depreciation / (depreciation + netPPE). Depi greater than 1 which shows that the rate at which assets are depreciated has slowed - Increase the likelihood that the company has revised upward the estimated useful lives of the assets or adopt new methods increase in revenue

#### 6. General and Administrative Expenses Sales Index (SGAI)

SGAI calculated as the ratio of SGA to sales in year  $t$  relative the appropriate size in year  $t - 1$ . Variables used follow Lev and Thiagarajan's suggestion (1993) that analysts will interpret the proportional increase in sales as negative signal about the company's prospects in the future.

## 7. Leverage Index (LVGI)

LVGI is the ratio of total debt to total assets in year  $t$  relative the corresponding ratio in year  $t - 1$ . A LVGI greater than 1 showed an increase in leverage. Variable is included to get debt covenants incentives for earnings manipulation. With leverage assumption that follow a random walk, LVGI implicit measure forecast error leverage.

## 8. Total Accruals to Total Assets (TATA)

Accrual amount is calculated as the change in working capital accounts other than cash less depreciation. Total or partial accrual thereof has been used in prior work to assess the extent to which managers make discretionary accounting choices to change earnings (Jones, 1991).

Earnings Manipulation according to this model is a company that has an M-score exceeded -1.78.

## 2.6. Stock Return

In this research, stock return is represented by Abnormal Return. Efficient capital market is a market that will react quickly to all relevant information. This is indicated by the change in price stock exceeds normal conditions, giving rise to abnormal return (Zaqi, 2006). Information held by the investor will be transformed in the form of ups and downs of daily transaction volume and frequency of transactions.

Testing information content is meant to see the reaction of an announcement. If the announcement contains information, the market is expected to be react at the time of the announcement is received by the market. Market reaction is indicated by the change in the price of the relevant securities where this reaction can be measured by abnormal returns (Jogiyanto, 2005). Budiarto and Baridwan (1999), states that the market reaction as a signal to the existence of a specific event information can affect the value of companies which reflected changes in the price and trading volume of the stock happens. The investors can make observations about the information stock trading volume that occurred. It also can perform observations on trading volume information associated with price stock. Stocks with high trading volume will generate a return high stock.

According Jogiyanto (2003 : 109), return is the result was obtained by investement activities. Return can be Realized return that has been happening and expected return that has not yet occurred but is expected to happen in the future. Realized return is a return that has happened. Realized return is calculated based on historical data. Realized return is important because it is used as one measure of performance of the company. Historical return is also useful as a basis for determining the expected return and risk in the future .

According Jogiyanto (2003 : 109), Expected return is the return which is expected will be earned by investors in the future. Unlike the Realized returns that has been happened, and vice versa, the expected return has not happened yet.

Expected return is a return that is used for making investment decisions. Return is significant compared to historical returns due to an expected return on the investment made.

While abnormal return is the excess of actual return to normal return. Here, normal return is the expected return (expected by investors). Therefore, abnormal return is the difference between the actual return that occurs with the expected return (Jogiyanto, 2003:434). Abnormal return is the one that commonly used as a measuring tool to measure market reaction to the information content of an event conducted by the issuer. An event is said to have contents of information if it will provide abnormal returns to the market, otherwise an event that have no information contents will not give abnormal return to the market.

## **2.7. Previous Research**

In this section, will be described previous research as the idea of researcher in conducting this research. In Beneish, Lee, and Nichols (2013) with title Earnings Manipulation and Expected Return used Probability of manipulation (M-score model) to detect earnings manipulation and the impact of conducting earnings manipulation to stock return. In their paper, they calculated M-score with eight variables, there are: Days Sales in Receivables Index (DSRI), Gross Margin Index (GMI), Asset Quality Index (AQI), Sales Growth Index (SGI), Depreciation Index (DEPI), General and

Administrative Expenses Sales Index (SGAI), Leverage Index (LVGI), Total Accruals to Total Assets (TATA) as the independent variable and stock return as the dependent variable. The result of their research stated that if higher of M-score will be lower of stock return.

Again in Roychowdhury (2006), researcher detected manipulation to avoid losses, he investigated patterns in CFO, discretionary expenses, and production costs for firm. According researcher, company value reflected by stock price. If company conducted earnings manipulation, it will impact to decrease of company value. Decreasing of value here means lower stock price and the impact goes to decreasing of company stock return.

In Abarbanell J and B.Bushee (1997) with title Fundamental Analysis, Future Earnings, and Stock Prices discusses about evidence that accounting-based signals defined to reflect familiar concepts of fundamental analysis can be used to predict future abnormal return. The signals pertaining to changes in gross margin and selling expenses also appear to capture information underused by the market about earnings beyond one year and/or risk. In their paper, we could see those signals will effect to company stock return

Previously, Beneish (1999) with title Detection Earnings Manipulation discussed about detection earnings manipulation and the result stated that earnings manipulation could be detected by several variables which are classified into 8

variables that will be used therefore in 2013 in Beneish, Lee, and Nichols with title Earnings manipulation and expected return.

## **2.8. Hypothesis Development**

According Beneish, Lee, and Nichols (2013), they discriminate manipulator and non-manipulator with used flag and not flagged with cut off -1.78. With Flag signs as manipulator if the M-score exceeded  $-1.78$  and not flag signs as non-manipulator if M-score is not exceeded  $-1.78$ . Here, in their research, suggest that flagged companies (those that merely look like manipulator) are associated with lower returns.

Same result with Roychowdhury (2006), according researcher company value reflected by stock price. If company conducted earnings manipulation, it will impact to decrease of company value. Decreasing of value here means lower stock price and the impact goes to decreasing of company stock return. Again, in Abarbanell and Bushee (1997), according researcher there is any fundamental signals and future earnings, clearly we could see those signals will effect to company stock return.

Financial report is one of the important information to investors because it can be used as a basis for decision making (buy or sell stock) in the capital market. The financial statements have information content that can reduce the uncertainty or change the expectations of the investors when they wanted to invest. In Jogiyanto



(2000), financial report publication has impact on market. According to his observation, there is investors' reaction towards share ordinary earnings of publications around the date of publication. Testing for the publication of the information content of annual earnings report found evidence that this will have an impact on the earnings announcement to abnormal stock price performance. Its mean market will react on financial report announcement.

Market reaction can be positive market reaction or negative market reaction. Market reaction conducted purchase action indicates a positive reaction, as investors have hopes for the future prospects of the company, the reverse reaction of the market when conducted stock selling action is a negative reaction, because it considers the company experienced a decline in earnings in the future so that the investor decides to sell the stock. In other words, the market reaction reflected by the actions of investors can be divided into sell stocks; buy stocks, and still holds the stocks. Market reaction in the form of action to sell and buy shares will impact to stock prices and the impact will go to stock returns finally.

Again, in Jogiyanto (2008), research study examines the market reaction to the events because the event has informative contents and market will react to the events that contain information. An event can be described as a surprise or something unexpected. The bigger surprise will impact to the bigger market reaction. Market reaction of an event is proxied by the abnormal return. Abnormal return is zero indicates that the market does not react to events that occur if the market reacts to

events that occur, it will be obtained abnormal returns significantly different from zero. Sign of abnormal return positive or negative indicates a direction of the market reaction is due to the good news or worse. Good news events are expected to react positively by market, and vice versa, the bad news will react negatively by market. An event or information regarded as good news or news poorly linked to the economic value it contains. If an event or information contained economic value increases the value of company, then categorized as good news. If the incident contain economic value lowers the value of the company, including as bad news.

The result of earnings manipulation will impact to the lower quality of earnings. Here, the impact of lower quality of earnings will impact to 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. So, based on the description above, researcher concluded this hypothesis below:

**Ha: Earnings manipulation with using M-score has negatively affected on stock return**