CHAPTER I

INTRODUCTION

1.1 Background of The Research

A financial statement is the result of the accounting process that gives information about the company’s performance. Financial statement is prepared and presented by management to the parties that concerned to the financial statements. The parties that concerned to the financial statement are internal users (agent) and external user (principle). The managers as the agent and the owner as the principle have their own interest. As an agent, a manager has responsible for optimizing the benefit of the owners (principle), but on the other hand the manager also has his or her own interest in maximizing their welfare. The manager has direct contact with the entity or company and know the significant events that happened in the company, based on this condition the manager know well the internal information of the company and also company’s prospect in the future than the owner (principal).

Imbalance information between the management as information providers and the shareholder as the user is called information asymmetry. According to Scott (2006) there are two kinds of information asymmetry those are adverse selection and moral hazard. Adverse selection, unbalance of information between the manager and the user, so would have an effect to the shareholder decision and the information does not give to the stakeholder. Moral hazard, not all activities
done by the managers in the companies known by the owner so the managers can
do their act outside the knowledge of shareholders. Asymmetry between the
management (agent) with the owner (principal) provides the opportunity for the
managers to act opportunistically, which personal gain. The way that can be done
by the manager is to do deviate action in the process of preparing financial
statements.

The objective of the financial statement is to provide financial information
demonstrate achievements of the companies to generate earnings. Earnings are
important measurement for the company to evaluate management performance.
Information contained in earnings has an important role in assessing the
performance of the company. Earnings quality is earnings that reflect relevance,
reliability, and comparability but to obtain the earnings quality, managers is often
conducted earnings management in financial statements. One way to conduct
earnings management is by increasing the earnings. This is done by the managers
in order to mislead the shareholder and the user of the financial statements
regarding the company’s performance. Earnings management can be described as
a management behavior in selecting particular accounting policy or through the
implementation of specific activities, which aim to influence earnings to achieve a
specific goal (Scott, 2009). According to Healy and Wahlen (1999), earnings
management happen when the managers use judgment in reporting financial
report and preparing transaction that will changes financial statements so, it will
mislead the entities that have an interest to the companies.
Earnings management can be classified into three categories which consist of accrual management, classification shifting, and real activities management. Usually a manager is more likely to use real activities manipulation rather than earnings management through accruals (Graham et al. 2005), Gunny (2005), Roychowdhury (2006), Zang (2006), (Cohen et al. 2008), as well as Cohen and Zarowon (2008) found that the managers had to sift from accrual management to the real activities management after period of Sarbanes-Oxley Act (SOX). There are two factors that cause chosen earnings management through real activities manipulation. First, accrual manipulation more often becomes the center of observation or inspection by the auditors and the regulators. Second, only focuses attention on accrual manipulation is risky action because the company may have limited flexibility to manage accrual (Graham et al. 2005).

Real activities manipulation is earnings management done by the managers which deviate from normal business practices aimed of achieving certain earnings. Managers are motivated to do real activities manipulation to attract investors to invest their fund to the company and these things will be a positive signal for the company. The purpose of real activities manipulation is done to avoid reporting losses by using the factors that affect the reported earnings that accounts are entered into the income statement (Oktorina and Hutagaol, 2003).

According to Roychowdhury (2006), the management can not rely on the act of manipulation through accrual in earnings manipulation because real activities manipulation is used if accrual can not reach the target. Moreover,
accrual manipulation can only be done in the end of period to reach the target, if not met then management may use manipulation through real activities conducted throughout the year and difficult to detect. Therefore, real activities manipulation is becoming alternative for the managers to set earnings.

Roychowdhury (2006), there are three technique can be performed in real activities manipulation includes sales, discretionary expense, and overproduction. A cash flow statement through cash flow from operations which consists of operational activities of the company is one type of financial statements no less important from income statements. The first method can be used to real activities manipulation through cash flow from operation is sales manipulation by giving price discounts and more lenient credit term to boosts sales. Increasing sales during the accounting period with the aim to increase earnings and achieve the desired profit target.

Second methods are to perform large-scale production (overproduction) by producing goods greater than that required to achieve the aims expected demand so profits increase. Produce large-scale of product where cost of production that is fixed overhead cost can be allocated to the large number of unit so the fixed cost will be lower and the cost of goods sold for producing goods would be smaller.

The third method can be used to real activities manipulations through discretionary expense with cutting cost include in discretionary expense which is advertising expense, research and development, and selling, general, and
administrative expense. This method is usually done when these costs do not
generate revenue and profits immediately. Oktorina and Hutagaol (2008) give an
evidence that the company is suspected tend to real activities manipulation
through cash flow from operation have higher market performance than the firms
that suspected tend not to real activities manipulation through cash flow from
operation.

Roychowdury (2003) found that the companies that tend to real activities
manipulation will show lower operating cash flow. Roychowdhury (2006) states
that real activities manipulation has negative impact for future company’s
performance. Real activities manipulation can reduce firm value because actions
taken in the current period to increase earnings can have a negative effect on cash
flows in future periods. For example, aggressive price discounts to increase sales
volumes and meet some short-term earnings target can lead customers to expect
such discounts in future periods as well. This can imply lower margins on future
sales. Through the description above, this paper will test whether the real
activities manipulation has negative affect on the future companies performance
or not. This paper will give additional evidence to support the research of
Roychowdury (2006) also.

1.2 Research Question

The company in Indonesia which has a good performance will give benefit
for the company it self, but having a good performance in the company is not
easy. The way that can be done by the company especially for the manager in
order to increase company’s performance is doing real activities manipulation.
Real activities manipulation is the practice that deviates from the normal operating practices. These things exactly can increase the company performance but along the way it will give negative impact for the company performance in the future. According to Roychowdury (2006), there are three techniques to be used in real activities manipulation those are sales manipulation, overproduction, and discretionary expense. Oktorina and Hutagaol (2008) give an evidence that the company is suspected tend to real activities manipulation through cash flow from operation have higher market performance than the firms that suspected tend do not do real activities manipulation through cash flow from operation. Roychowdhury (2006) states that real activities manipulation has negative impact for future companies’ performance. Based on the explanation above, the problem in this study, does real activities manipulation negatively affect future performance?

1.3 Objective of The Research

Based on the problem that already discussed the impact of real activities manipulation through cash flow from operation for future performance, the researcher want to document how real activities manipulation through cash flow from operation has negative impact on the future performance.

1.4 Research Contribution

The result of this paper will have some benefit especially for the writer, investor, and for reader.
1. Investor

The information contained in this study can be used by investors as additional knowledge and consideration for investors to be more cautious when investing their funds.

2. Academics

The result in this study is expected to be a reference for the next researcher who is interested in examining earnings management practices through real activities manipulation by adding or changing the variables of this study.

1.5 Systematic

CHAPTER I   : INTRODUCTION

Chapter 1 is the introduction part which consists of research background, research question, research objective, and also systematic of writing.

CHAPTER II   : THEORITICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Chapter 2 contains explanation about SFAC related to the quality information, agency theory, positive accounting theory, earnings management, earnings management through
real activities manipulation, cash flow, cash
flow from operation, and hypothesis
development.

CHAPTER III  : RESEARCH METHODOLOGY

Chapter 3 explained the population and
research sample, data and the source of data,
definition of variable and measurement, data
analysis method, and hypothesis test.

CHAPTER IV  : DATA ANALYSIS AND DISCUSSION

Chapter 4 consists of the analysis data that
has been calculated at the previous chapter
and being observed to find the conclusion.

CHAPTER V  : CONCLUSION AND LIMITATION

Chapter 5 consist of conclusion of the
research that has been done, limitation of the
research, and suggestion for the next researcher