CHAPTER II

THEORITICAL FRAMEWORK AND HYPHOTHESIS DEVELOPMENT

2.1 Statement of Financial Accounting Concepts No. 8

SFAC No. 8 related to the quality information and the purpose of financial statements is provide financial information that useful for who has enough comprehension about business activities in decision making either invest or credit. According to SFAC No 8, the characteristic of the quality information is divided in to two categories those are the main quality and supporting quality. The main quality includes Relevance and Faithfull Representation.

1. Relevance

   Relevant financial information must be capable of making difference in a decision making made by users. The information said to be relevant with the criteria:

   a. Predictive Value

      Financial information has predictive value if it has value as an input to predictive processes used by investors to form their own expectations about the future.

   b. Confirmatory Value

      Relevant information also helps users confirm or correct prior expectations.

c. Materiality

Information is materialif omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

2. Faithfull Representation

Financial reports represent economic phenomena in words and numbers and to be useful, the financial information not only represents relevant phenomena but also must faithfully represent the phenomena that are purports to represent. There are three characteristics to make a perfect representation of the value of information, as follows:

a. Completeness

Completeness means that all the information that is necessary for faithful representation is provided.

b. Neutrality

Neutralitymeans that a company cannot select information to favor one set of interested parties over another.

c. Free from error

An information item that is free from error will be a more accurate (faithful) representation of a financial item.

The supporting quality includes Comparability, Verifiability, Timeliness, and Understandability.

1. Comparability

Comparability is the qualitative characteristichat enables users to identify and understand similarities in and difference among items. Consistency is not the same as the comparability because of consistency refers to the use of the same method for the same items while comparative assist in achieving these objectives.

2. Verifiability

   Verifiability is used to help the use of information that faithful information is the economic phenomena that has the purpose to represent. Verifiability may be direct or indirect. Direct verifiability means verify the amount or other representation through direct observation. Indirect verifiability means checking the input to the formula, models or other technique and recalculates the output using the same methodology.

3. Timeliness

   Timeliness means having information available to decision-makers before it loses its capacity to influence decisions. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period because for the example some users may need identify and assess trends.

4. Understandability

   Classifying, characterizing, and presenting information clearly and concisely makes it understandable.

2.2 Agency Theory

Perspective of agency theory is the basis used to understand the issue of corporate governance and earning management. Agency theory defines as relation between the principal (shareholder) and the agent (management). Jensen and Meckling (1967) defines that the agency relationship as a contract under which one or more person (the principals) engage another (the agent) to perform some service on their behalf which involve delegating some decision making authority to the agent. Furthermore, if both parties have same goals to maximize the value of the companies, it is believe that the agent will act in a manner consistent with the interest of the principals.

Scott (2006) states that the companies have many contracts for instance employment contract between company with the managers and loan contract between the company and its creditors. Here, the employment contract means that between agent and principal want to maximize theirown utility with the information held. Asymmetry arises because agent as the manager has full information compare to the principal as the owner. Furthermore, a more information about company held by the agent causes the manager to do exactly the actions in accordance with their interests to maximize their welfare.

Scott (2006) states that there are two kinds of information asymmetry those are:

1. Adverse selection

   The managers as well as insider usually know more about company prospect that the investor as the outsiders and the fact may influence the decision to be taken by shareholder, sometimes not communicated the information to the shareholder.

2. Moral hazard

   The activities undertaken by a manager is not entirely unknown by shareholder and leaders, so managers can take action beyond the knowledge of shareholder.

Einsenhardt (1989) states that agency theory use three assumption of human nature which are:

1. Assumptions about human nature

   Assumptions about human nature emphasizes that human beings have the nature to be selfish (self-interest), have limited rationality (bounded rationality), and do not like the risk (risk aversion).

2. Assumptions about organizational

   Assumptions organizational are a conflict between members of the organization, efficiency as criteria of productivity, and the presence of Asymmetric Information (AI) between the principal and agent.

3. Assumption about information

   Assumptions about information are that the information is viewed as a commodity item that can be traded.

2.3 Positive Accounting Theory

Positive accounting theory (PAT) is a theory developed by Watts and Zimmerman in year 1978 and was published through their writing in year 1978 and 1979. Positive accounting theory (PAT) is intended to explain and predict the consequences that occur when managers determine a particular option. Explanation and prediction in PAT is based on the contract (contracting process) or agency relationship (agency relationship) between the manager and other groups such as investors, creditors, auditors, the manager of capital markets and government institutions (Watts and Zimmerman, 1986).

Watt and Zimmerman (1986) states that are three background hypothesis in applying earnings management on positive accounting theory.

1. Bonus Plan Hypothesis

   The company which has a bonus plan for its manager, the manager will be motivated to increase the company performance financially. If the financial performance not going well, the manager will be highly positive to perform specific method in order to increase or maintain the growth of income.

2. The Debt to Equity Hypothesis (Debt Convenant Hypothesis)

   Motivation arises because the contract agreement between manager and the owner of the company based on managerial compensation and debt covenant.

3. The Political Cost Hypothesis

   Motivation political regulation is motivated in management to anticipate various government regulations. Management exploits weaknesses using the estimated accrual accounting and the selection of the accounting methods in order to deal with the various regulations issued by the government.

2.4 Earnings Management

Earnings management is an action taken by the manager to raise or lower the reported earnings and the action will not provide economic benefit for the company, so in long term it will harm the company. Scott (1997) defines earnings management as given provide an opportunity for the manager to choose the accounting policies, for instance GAAP. It is natural to expect that they will choose policies to maximize their own utility or the value of the firm. The statement define by Scott (1997), earnings management can be policy that some corporation can apply from accounting standards and can minimize their utility by using flexibility that stated in accounting standard. Earnings management can be classified into two criteria those are opportunistic earnings management and efficient earnings management. Opportunistic earnings management, the situation occurs if the management wants to maximize their utility for opportunistic purposes. Efficient earnings management, the situation occur if the management want to prevent unconditional factor in business environment especially maintain the rate of income for parties that associated in contract.

Scott (2006) is divided earnings management into four pattern those are:

1. Taking a bath

   Taking a bath is a pattern of earnings management that is done by making corporate earnings for the year to be extremely low or extremely high compare to the earning before and after. Taking a bath occurduring the period of the pressure at the time of organization or reorganization, such the turn of new CEO. Recognize the cot in the future periods and losses during the year when the condition are not favorable and bad can not be avoided during the year. As the result, earnings in the next period will be higher than it should be.

2. Income minimization

   Income minimization is the pattern of earnings management to make earnings in the financial report lower than it should be. Income minimization usually performed when the profitability of the companies are high with the intention that no political attention. The policy is taken such as removal of capital goods, intangible assets, advertising expenditure, and research and development expense.

3. Income maximization

   Income maximization is the pattern of earnings management to make earnings in financial report during the year higher than it should be. Income maximization performed with the aim to generate higher bonus, increase profit, and avoid the violation of the contract of long-term debt. Income maximization is done by accelerating the recording of revenue, and postpone and moving cost to another period. The action on income maximization aims to report higher net income for the purpose of large bonus.

4. Income smoothing

   Income smoothing is the pattern of earnings management is done by making a relatively consistent accounting profit from period to period. In this case the management intentionally lowering or increasing the profit to reduce fluctuation in reporting earnings, so the company looks stable at high risk or not. Furthermore, when current income is relatively low now but the future earnings expected to be relatively high, then the manager will make the selection of accounting method that can increase earnings during the years with the loan of earnings in the future period. Meanwhile, when current income is relatively low now but the future earnings expected to be relatively high, then the manager will make selection of accounting method that will decrease earnings during the period to be allocated to the future earnings.

2.4.1 Earnings Management Through Real Activities Management

Real activities manipulation is the practice that is separate from the normal operating practices that is motivated by the manager in order to mislead the shareholder in a certain belief the purpose of the financial statements have been met in the normal operation. This separation is not necessarily gives contribution to the company's value, although it enable managers to meet the goals of reported. Two factor that cause chosen earnings management through real activities manipulation. First, accrual manipulation more often be the center of observation or inspection by the auditors and regulators. Second, only focuses attention on accrual manipulation is a risky action.

Real activities manipulation method such as a price discount, overproduction, and reduction of discretionary expenditure allow optimal action in particular economic condition. The manager has an incentive to do real activities manipulation along the year to achieve certain target. The manager is doing real activities manipulation to avoid losses in the year of financial statement. In specific, there are some evidence support that discount price with increasing price temporally in the production to report lower cost of goods sold and also reduction of discretionary expenditures to increase margins reported. In detecting earnings management through real activities manipulation done by the company, Roychowdhury (2006) uses model focus on three manipulation method those are :

1. Sales Manipulation

   Sale manipulation is the way to increase sales on a temporary basis in a given period by offering discounted prices to excess product or provide a more lenient credit terms. These strategies can increase sales volume and current period earnings, with the assumption of positive margin. Giving price discounts and more lenient credit terms will reduce the current period cash flow.

2. DiscretionaryExpense

   The company can reduce discretionary expenditures such as research and development expenses, advertising, and selling, general and administrative expense, especially in a period in which the expenditure is indirectly cause revenues and profits. This strategy can improve profitability and cash flow period, but it risky for the company that is lowering the future cash flow.

3. Overproduction

   The manager of the company can produce more that is required by the assumption that the higher level of production can lead lower fixed cost per unit. This strategy can reduce cost of goods sold and increase operating income.

2.5 Cash Flow

Cash flow is a financial report containing the influence of cash from operating activities, investing activities and funding activities and the increasing or net decreasing in cash of an enterprise during a period. According to Lerner (1971) cash flow is an increase in the amount of cash generated by operating activities during the specified time, consist of income after tax plus the sum of depreciation, being account debts and assets remain unchanged. Furthermore, Graham Mott (1985) states that the cash flow is used to explain the financial statements, which is operating profit after deducting the tax and dividend payment by adding back depreciation expense for the year.

Brigham and Houston (2001) states that cash flow is the cash inflows by operating expenditure required to maintain the operating cash flow in the future. Cash inflow is greater than cash outflow it shows positive cash flow. Otherwise, when cash inflow is less than cash outflow it means negative cash flow. Three activities are presenting financial statements accordingto PSAK No 2.

1. Investing activities

   Acquisition and disposal of long term-term assets and other investment not included in cash equivalent.

2. Operating activities

   The operation as the revenue-producing activities of entity and other activities that are not investing activities and financing activities.

3. Financing activities

   The activities that resulting in changes in the amount and composition of capital contribution and loans entities.

Hogren et al. (2000), cash flow statements is designed to fulfill to meet the following objective:

1. Estimating future cash flows. Source of use of corporate cash is not changed dramatically from year to year. Therefore, cash receipts and disbursements can be used as a tool to estimate cash receipts and disbursements in the future.
2. Evaluating management decision making. Cash flow statement reports the company's investment activities, thereby providing cash flow of information to investors and creditors to evaluate the manager's decision.
3. Determining a company's ability to pay dividends to shareholders, interest and loan principal payments to creditors.

4. Statement of cash flows helps investors and creditors to determine whether the company can make these payments.
5. Shows the relationship of net income to changes in the company's cash.
6. The possibility of bankruptcy of a company that has a sufficient net income but have low cash informal causes the need for cash flow.

2.5.1 Cash Flow from Operation

PSAK No 2 explained cash flow from operation that come from revenue-producing activities and other activities that are not investing activities and financing activities. Cash flow from operation as the indicator to explain whether the company can generate enough cash to pay off loans, maintain the operating capability of the company, pay dividends and make new investments without relying on external sources of financing. Cash flow from operation usually derived from transactions or other events that affect the profit and loss provision. Some of the example of cash flows from operating activities:

1. Cash receive from selling goods and services.
2. Cash receipt from royalties, fees, commissions and other revenue.
3. Cash payments to suppliers of goods and services.
4. Cash payments to employs
5. Cash receipts and payments by insurance entities for premium and claims, annuities, and others insurance benefit.

6. Cash payments or receipts for income tax return unless specifically identified as part of the financing and investing activities.
7. Cash receipts and payments from contracts held for trading purposes and business transactions.

PSAK No. 2 (2009) there are two methods in reporting cash flow from operation:

1. Direct method

   This method reveals the major groups of gross cash receipts and gross cash. In this method each estimate base on accrual basis in income statements converted into estimate revenue and cash expenditure so described the actual cash receipt and payment. Thus, it can conclude that direct method focus on cash flow rather than net income accrual, and therefore considered to be more informative and detailed.
2. Indirect method

   Net income or loss adjusted to correct the effect of non-cash transaction, deferral or accrual of cash receipt or payment for operation in the past and the future, and items of income or expense associated with investing and financing cash flow.

IAI (2009) is recommended the company for using direct method because this method can generate information in estimating future cash flow where cannot be generated with indirect method. However, the use of direct method in preparing cash flow statements is difficult and need longer time compare to indirect method.

2.6 The Impact of Real Activities Manipulation for Future Performance

The real activities manipulation is performed to avoid reporting losses by using the factors that affect the reported earnings (Oktorina and Hutagaol, 2008). The companies have certain goals to be achieved in an effort to meet the interests of its members. Success in achieving the company's goals is an achievement of management. Performance assessment usually used by internal and external parties in decision making. According to Rochowdhury (2003), increasing earnings through real activities manipulation use three techniques those are sales manipulation, overproduction, and discretionary expense. The financial report as a benchmark to measure whether the company has a good performance or not. Continuous earnings growth increasing from year to year gives a positive signal about the future prospects of the company because profit is a measure of the performance of the company The investor usually want to invest their fund to the company if the companies have a good prospect not only in the present but also in the future.

2.7 Previous Researcher

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). Earnings as a company's performance parameters have an attention from the investor and creditor to be used to evaluate management performance. Therefore, earnings that provide positive signal will provide an interest for the investor to invest their money to the company. The differences in operating practices are performed with normal operating practices, motivated by management's desire to provide an incorrect understanding to shareholders, so they believe that certain financial reporting objectives have been achieved according to the company's normal operating practices Roychowdhury (2006).

Roychowdhury (2003) found that the companies that tend to do real activities manipulation will show lower operating cash flow. Oktrina and Hutagaol (2008) found that the company with real activities manipulation through cash flow from operation hashigher market performance than firm that allegedly tend not to do real activities manipulation through cash flow from operation.

Graham et al. (2005) found that the manager like to use real activities manipulation rather than earnings management through accrual. Choosing real activities manipulation because more difficult to detect although the cost incurred with those activities economically significant to the companies. Consistent with Graham et al. (2005), Cohen (2007) found that the manager shifting from accrual to the real activitiesmanipulation in the period after Sarbanes-Oxley Act (SOX). Zang (2006) found that the company with higher earnings management in the last period tends to use real activities manipulation rather than accrual.

2.8 Hypothesis Development

Earnings management is one factor that can undermine the credibility of the financial statement. There are several ways that made by management in conducting earnings management, through accrual earnings management and real activities manipulation. Potentially real earnings management is motivated by the pressure or boost managers to generate short-term profits and low management focus on Long-term plans. Motivation to generate short-term profits will lead the management to act opportunistically, so management will focus excessively on the values or activities that affect earnings. Real earnings management undertaken by the manager to show sort term performance of the company that is good, but it potentially will decrease the value of the company itself.

Real activities manipulation can reduce firm value because actions taken in thecurrent period to increase earnings can have a negative effect on cash flows in futureperiods. For example, aggressive price discounts to increase sales volumes and meet someshort-term earnings target can lead customers to expect such discounts in future periods as well and this can imply lower margins on future sales(Rochowdhury, 2006). The purpose of real activities manipulation to avoid reporting earnings losses by using factors that impact to the earnings which is reported to the accounts are entered to the income statements.

Real activities manipulation through cash flow form operation result in increased profit, profit is a measure of financial performance. Continuous earnings growth from year to year will give positive signal about company's prospect, higher earnings generated by company indicated the better the performance of the company. Therefore, if managers do real earnings management current year the company's earnings will increase and improve company's performance, but in the next year the performance of the company will decrease.

H1: Real activities manipulation negatively affect future performance