CHAPTER 1

INTRODUCTION

1.1 Background

Earnings provides a measure about how well firms currently deployed their resources to generate profit (Burgstahler and Dichev 1997). Furthermore, earnings is also viewed as the significant predictor of future cash flows (Pariwiyati and Baridwan 1998 in Sitanggang 2006). Its usefulness makes earnings being viewed as one alternative to value the business performance (Whelan and McNamara 2004), thus, it is a determinant to allocate the investors' wealth. Earnings that is useful, hence value relevant, can predict the movement of stock prices/returns (Ball and Brown 1968, Raffoumier and Dumontier 2002 in Fattahi, MoeinAddin, and Abtahi 2014).

The value relevance of earnings can be affected by the presence of earnings management (Whelan and McNamara 2004, Fattahi, MoeinAddin, and Abtahi 2014). Through earnings management, managers can choose which kind, accounting policies (accrual earnings management) or real actions (real earnings management) that can affect earnings number (Scott 2012, page 423). Bad motivation can lead managers to use earnings management. This type of earnings management is termed as opportunistic earnings management (Scott 2012, page 442).

Earnings which is managed opportunistically, tends to distort the qualitative characteristic of relevance and reliability of earnings information (Whelan and McNamara 2004, Chang and Shiva 2010, Fattahi, MoeinAddin, and Abtahi 2014). In that way, earnings represent bad quality of information ((Dechow et al. 2009). As a response, investors will seek another source of information to assess firm performance. Earnings information becomes less decision-usefulness (Dechow et al. 2009). The less decision usefulness of earnings information, the less value relevance of earnings information (Whelan and McNamara 2004, Fattahi, MoeinAddin, and Abtahi 2014).

Most of the previous research documented earnings management decreases the value relevance of earnings, yet, it provide many result. According to Himma (2013) and Subekti (2010), accrual earnings management decreases the value relevance of earnings. Furthermore, Marquard and Wiedman (2006) also conclude that earnings management decreases the value relevance of earnings due to seasoned equity offering. In contrast, Fattahi, MoeinAddin, and Abtahi (2014) conclude that there is no significant relationship between earnings management (using aggregate earnings management) and value relevance of accounting information. Many different outcome produced, means that there is a wide chance to explore more about earnings management and the value relevance of earnings in scope of Indonesia stock market.

In the end, this topic is worth researching because it involves the valuation process. Valuation process is important to ensure the usefulness of accounting information, only with that, the investors can make a good decision to allocate their wealth appropriately.

1.2 Research Question

The key question of the relation between earnings management and the value relevance of earnings can be summarized as follow.

Does earnings management negatively affects the value relevance of earnings?

1.3 The Objective of Research

This research has an objective to prove that empirically earnings management negatively affects the value relevance of earnings.

1.4 The Contribution of Research

This research is expected to give contribution as follow:

1. As academic purpose, this research is to test the previous model of accruals earnings management towards the value relevance of earnings in Indonesia stock market.
2. As managerial purposes, this research is to test whether the earnings management negatively affects the value relevance of earnings.