# CHAPTER I

# INTRODUCTION

## 1.1 Background of Research

Financial statements is the final of the accounting process that has an important role for the measurement and assessment of company performance. Related to this, the financial statements have an important function as a tool of communication between management and stakeholders. According to SFAC Num. 8 (2010), there are four qualitative characteristics of useful financial information: comparability, verifiability, timeliness, and understandability.

SFAC Num. 8 (2010) also stated the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. In connection with the characteristics of useful financial information, earnings information being the main focus of financial statement user where earnings act as performance tool for management and also a part for company information.

In practice, companies are more likely to rule out the presentation of high quality earnings information and perform various manipulations. In accounting and financial practices, the manipulation is called earning management.

According to Scott (2012) earnings management is the choice by a manager of accounting policy to achieve some specific objective. According to that statement shows that earnings management is a choice of accounting policy by the manager in giving the specific goals. Earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial report to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy and Wahlen, 1998).

According to Sanjaya (2012) there are three ways to manage earnings, namely accruals earnings management, real activities manipulation, and shifting of core expense. The most famous way in managing the earnings are accruals earnings management and real activities manipulation. According to Zang (2012) accrual earnings management and real earnings management plays a role substitution. When the accrual earnings management is limited, the company will tend to do real earnings management to manage earnings.

Recent research shows increased appreciation for the importance of understanding how firms manage earnings through real activities manipulation in addition to accrual-based activities (Zang, 2012). Based on previous studies, there are three essential reasons for managers to manipulate earnings through real operating activities. First, Cohen et al. (2008) find evidence that managers have shifted away from accrual-based to real earnings management in the post Sarbanes-Oxley Act (SOX) period. After financial scandals such as Enron, World.Com, etc. and the passage of the Sarbanes and Oxley Act (SOX) in 2002, accrual earnings management is likely to draw more scrutiny by auditors, regulators, etc., thus firms would have less flexibility in accrual-based earnings management. So firms have more incentives to engage in real earnings management. Second, according to Zang (2012), relying on accrual earnings management alone might be inadequate and risky. If reported earnings after accrual earnings management are still below the targeted earnings threshold, then it would be too late for managers to engage in real earnings management because it takes time to be realized and cannot be manipulated at the end of year. Third, according to Roychowdury (2006), there are two reasons why executives are more likely to use real activities manipulation: (1) manipulation of accruals tends to attract an auditor or regulator more to supervise than a real decision does (2) compared with the manipulation of real activities manipulation, accrual manipulation is riskier. At the end, managers do not prefer to use accrual earnings management because it is riskier and the auditors will easily know.

According to Roychowdury (2006), real activities manipulation is defined as management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings threshold. There are three ways to do real activities manipulation: (1) 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. (2) reduction of discretionary expendituеs: by 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. (3) 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.

Scott (2012) divided understanding of the earnings management into two. First, see it as opportunistic behavior of managers to maximize utility in dealing with compensattion contracts, debt contracts, and political cost (Profit Opportunistic Management). Second, by looking at earnings management from the prespective of efficient contracting (Efficient Earnings Management), where earnings management give managers a flexibility to protect themselves and the company in order to anticipate unexpected events for the parties' benefit that get involved in the contract

Beneish (2011) stated that earnings management arise as a result of agency problems, namely the misalignment of interests between principal and agent. Owner of the company as a supplier of the company's capital to delegate authority over the management of the company to a proffesional managers. As a consequence, the use of resources is entirely in the hands of the executive managers. This resulted in an effective management control over the company's interest

The separation of ownership by principal and control by agent in a company is inclined because agency conflict between principal and agents (Watts and Zimmerman, 1989). In this such condition, required a control mechanism to align the differentation between the management and principal's interest. Hence, good corporate governance is considered necessary. Komite Nasional Kebijakan Governance (KNKG) (2006) defines corporate governance as a process and structure that is used by the company in order to give add value to the company on going to the long term for shareholders, while paying attention to the stakeholders interests, based on the legistation rules and norms. Corporate governance centers on processes designed to ensure that directors and managers of companies are held properly accountable to their shareholders. They must perform their duties with integrity and be subject to checks and balances which prevent abuse of power.

According to Cadbury (1992), corporate governance is the system by which companies are directed and controlled. Good corporate governance (GCG) in a corporate set up leads to maximize the value of the shareholders legally, ethically and on a sustainable basis, while ensuring equity and transparency to every stakeholder – the company's customers, employees, investors, vendor-partners, the government of the land and the community (Millstein, 2002; Murthy, 2006). The above statement is in line with the statement of Watts and Zimmerman (1986), corporate governance attributes help investors by aligning the interests of managers with the interests of shareholders and by enhancing the reliability of financial information and the integrity of the financial reporting process.

Corporate governance becomes an important issue after the 1997 – 1998 monetary crises that hit several countries in Southeast Asia, including Indonesia. Several earnings management related international frauds and accounting scandals such as Enron, Worldcom and Parmalat in the United States and Kimia Farma and Bank Lippo in Indonesia to mention but a few, has fuelled public and government concern about the potency of corporate governance in ensuring that corporate reports communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information.

Those cases prove the lack of good corporate governance practices are still commonly found. Riyanto (2005) stated that shareholders expect managers can act proffesional. All that is done by the management should aim to increase the value or quality of the company. But what often happens is that everything is done management is not solely for the welfare of the company, but also to improve the personal well-being. According Darmawati et al. (2005), act of selfishness on the part of the manager is the main characteristic of weak corporate governance. This is supported by Berghe and Ridher (2005), that the company that has poor performance is due to poor governance.

This phenomenon has prompted many researchers in order to examine whether there is a significant effect of the implementation of good corporate governance by several proxies: characteristics of board of commissioners, audit committee characteristics and audit quality on earnings management through real activities manipulation. Several researchers who have conducted research related to the implementation of good corporate governance influence on earnings management are Pierce and Zahra (1992), Fama and Jensen (1983), Beasley (1996), Dalton et al. (1999), Bradbury et al. (2006), Weir et al. (2002), Ho and Williams (2003), Mangena (2007), Chaganti et al. (1985), Siregar and Utama (2008), Waryanto, 2010), DeAngelo (1981), Becker et al. (1998), Francis et al. (1999), Veronica and Utama (2005).

The effect of board of commissioner size on earnings management is mixed though it has significant effect on firm performance (Pierce and Zahra, 1992). Fama and Jensen (1983) believe that the board of commissioners is a vital element in implementing corporate governance; essentially, it is implemented in order to protect and supervise the investors' assets, and no supervisory mechanism, even delegating the supervision to other parties, is more effective than direct supervision by stockholders. Beasley (1996) conclude that lower board of commissioner size leads to more effective monitoring. Larger board of commissioners is seemed to be less effective in playing their roles as there are communication problems, coordination, and decision making. Conversely, Dalton et al. (1999) and Bradbury et al. (2006) contend larger board of commissioner size will provide better business management that will limit the level of earnings management.

Board composition refers to the number of independent commisioners in comparison with the total of the board commissioners' members. The board composition must enable an effective, accurate, and fast decision-making. Independent commisioners have the task to ensure a balanced decision-making, especially to protect minority stockholders and other relevant parties. Weir et al. (2002) and Ho and Williams (2003) believe that board effectiveness tends to increase when the company has non-executive directors (equivalent to independent commissioners), as non-executive directors have more independence in the management (Mangena, 2007). Other studies, such as Chaganti et al. (1985) and Weir et al. (2002) do not find any relationship between board's independence and firms' performance. In addition, Chtourou et al. (2001); Siregar and Utama (2008) also do not find any relationship between board's independence and earnings management.

In performing its duties the board of commissioners may establish committees that support the implementation of good corporate governance in the company, one of which is the audit committee (Waryanto, 2010). Audit committee is another corporate governance mechanism. The audit committee must be composed of entirely non executive members to be effective. Accordingly, their existence should improve the practice of good corporate governance in the firm, which in turn will reduce information asymmetry and opportunistic earnings management. Audit quality according to DeAngelo (1981) is the probability an auditor will discover fraud in accounting system and report the fraud. Therefore, audit quality should reinforce the quality of firm financial reporting and in turn will reduce information asymmetry between firm management and firm shareholders. Prior study also report that good audit quality constraints opportunistic earnings management (Becker et al. 1998, Francis et al. 1999). Such findings are contraty to the researches done by Veronica and Utama (2005), audit committee has no effect on earnings management.

Through the description from severeal prior studies above, researchers assume that there is a significant effect of the implementation of good corporate governance to earnings management through real activities manipulation. Practically, the research is intended to provide actual contribution to the development of the reviews related to earnings management through real activities manipulation and the impact of good corporate governance implementation.

**1.2 Problem Statement**

Real activities manipulation is a separated practice of company's normal operation that is motivated by the desire of manager to mislead the shareholders. The management opportunistic action is the impact of agency conflicts. Implementation of good corporate governance is expected to be able to overcome this agency problem. Empirical studies prove that good corporate governance can reduce the tendency of management to do accrual earnings management practices.

Implementation of corporate governance mechanisms is believed to minimize the behavior of earnings management and improve financial performance company. With reducing the act of earnings management the company financial performance will increase and the external parties will not wrong in decision-making at the company.

The formulation of the problem to be studied related to the influence of good corporate governance implementation on earnings management through real activities manipulation stated in the question: **whether the characteristics of the board of commissioners; characteristics of the audit committee; and audit quality affect real activities manipulation?**

### 1.3 Research Objectives

This study aims to give empirical evidence on the characteristics of the board of commissioners, characteristic of the audit committee, as well as the effect of audit quality on real activities manipulation.

### 1.4 Research Purposes

1. For academic environment

   The result of this research is expected to be used as additional for empiric evidence about the impact of corporate governance on earnings management through real activities manipulation. Another expectation from this reserach is better result in the academic through this reserach.

2. For investor

   The result of this reserach is expected to be used as material for considering the investment decision. This reserach is expected to provide a broader knowledge of the community who involved in the financial business world. With this knowledge both of the reader and investor could be help in their trading decision. This research does expected to identify the impact of good corporate governance on earnings management through real activities manipulation.

3. For manufacturing companies

   The result of this reserach is expected to be used as evaluation material and implementation of corporate governance to companies in the future. This research also would be a measurement of financial statement relevancy in the company, then it will minimized the occuring of real activities manipulation.

4. For financial services authority

   The result of this research is expected to be used as a consideration material for regulator parties to improve and evaluate the regulation of corporate governance.

**1.5 Research Report Outline**

The writing is divided into five chapters, which are:

**Chapter I Introduction**

This chapter will discuss the introduction about the research. The introduction consists of research background, problem statement, scope of there search, objective of the research, benefit of the research, and research report outline.

**Chapter II Theoretical Background and Previous Research**

This chapter contains the related theoretical background, and previous research from this topic.

**Chapter III Research Methodology**

This chapter describes the population and sample used in this research, data and data gathering, variable and variable measurement, method of analysis and hypothesis testing.

**Chapter IV Data Analysis**

This chapter provides and presents the data analysis and discusses the result obtained in this study.

**Chapter V Conclusion and Suggestion**

This chapter consists of conclusion, limitation of the research, and suggestion for further research.