CHAPTER II

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Agency Theory

Agency theory addresses the relationship where in a contract 'one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent' (Jensen and Meckling, 1976). This happens because of the separation of the ownership and control, when the owner of the company or the board of directors (the 'principals') have to employ managers ('agents') to run the business and need to monitor their performance to ensure they act in the owner's interest.

Economist Alchian and Demsetz (1972) were the first to argue that monitoring the performance of individual work effort is always a cost of any firm and that organizational inefficiencies are created when the flow of information on individual performance is decreased or blocked. This can happen if there are large teams, unsuppervised proffesionals, or executives of corporations who act autonomously.

The main concern of agency theory as proposed by Jensen and Meckling (1976) is how to write contracts in which an agent's performance can be measured and incentivized so that they can act with the principal's interests in mind. Based on the idea that employees (at any level) will have diverse goals, two main agency problems are identified: how to align the conflicting goals of principals and agents, and how to ensure agents perform in the way principals expect them to. These problems can occur when executives or managers make self-interested decisions and manipulate information on performance, perhaps by moving numbers around or by 'creative accounting' to present better performance figures: 'The problem here is that the principal cannot verify that the agent has behaved appropriately' (Eisenhardt, 1989).

Eisenhardt (1989) stated that agency theory uses three basic assumptions of human nature, namely: (1) self interest, (2) bounded rationality, (3) risk averse. According to the basic assumption of human nature, manager as a human will act opportunistically, that is used their own interest. Individuals will always act in an opportunistic manner to the extent that their actions will increase their wealth. The relationships between various individuals consist mostly of a delegation of duties of one party to another party. When decision-making authority has delegated, this can lead to some loss of efficiency and consequent costs; agency costs. The main problem that arises with the delegation of duties is conflicts of interest. Because all individuals will driven by self–interest, the interest of the one may be in conflict with the interest of the other. The separation of control and ownership and the conflicts of interest lie at the bases of the agency theory. The main goal, from the shareholders perspective, would be to maximize the corporate performance by generating a high profit for the corporate. However, on the other hand the agency theory tells us that the agents will act in an opportunistic manner to maximize their rewards. Hence, the interests of shareholders are in conflict with the interests of the agents.

Because of the opportunistic behaviour of individuals, organizations will try to put in place mechanisms that have to align the interests of the agents and the principals. Contracts for example will use with the intention of ensuring that all parties, acting in their own self-interest, are at the same time motivated towards maximizing the value of the organization (Deegan and Unerman, 2006). These mechanisms however, will not always be effective to avoid earnings management by managers. The agency problem will cause that managers are able to give a misrepresentation of the earnings figure, either in positive or in negative manner, without the opportunity of stockholders and others to see through.

As stated by Smith and Watts' (1983) a firm itself can considered as a nexus of contracts. Those contracts will use to ensure that all individuals acting in their own self-interest are at the same time motivated towards maximizing the value of the company (principal's interest). Information asymmetry can exist between the agent and the principal due to the insider knowledge of the agent. Main problem with this relations is that the agent, management, has an information advantage over the principal, company. Research Richardson (1998) showed a positive relationship between information asymmetry and earnings management.

When considering the practice of earnings management, the agency theory explains the existence of the incentive for management to use earnings management. As explained previously managers tend to have an information advantage over the principal due to the day-to-day information and the insider knowledge. The incentive to use earnings management can arise from conflicts of interest, for instance when the goals of the management differ from those of the shareholders. Furthermore, management could try, by using earnings management, to mislead shareholders by showing a different image of the company's earnings. Management could allow shareholders to believe that the earnings are higher or lower than they actually are. Evidently the use of earnings management will used to improve managements own situation, either directly at the cost of the company or by improving the company's situation.

Behavior opportunistic management is the result of the agency relations that is capable of being constrained and controlled through an implementation of good corporate governance. Good corporate governance that is based on agency theory is expected to be capable of being a tool that can ensure the principal about the return of their capital already received rightly.

2.2 Positive Accounting Theory

The positive accounting theory, developed by Watts and Zimmerman (1986), tries to explain and predict accounting practice. As Watts and Zimmerman (1986) state: positive accounting theory is concerned with explaining accounting practice. It has designed to explain and predict which firms will and which firms will not use a particular method but it explains nothing as to which method a firm should use. Based upon the definition as given by Watts and Zimmerman a positive theory describes empirical observations without a valuation of those observations. A positive theory tries to predict and describe economic accounting behaviour.

The positive accounting theory focuses on the relationship between the various individuals involved in providing resources to an organization and in which way accounting can use to assist in the functioning of these relationships (Deegan and Unerman, 2006). The positive accounting theory has based on the central economic assumption that actions of individuals will driven by self-interest. As described by Deegan and Unerman (2006), individuals will always act in an opportunistic manner to the extent that their actions will increase their wealth. The positive accounting theory predicts based on the assumption that self-interest drives all individual actions that organizations will seek to put mechanisms in place to align the self-interest of the managers of the firm with the interest of the owners of the firm. The positive accounting theory focuses on the choices of accounting methods and the implications of these choices.

The positive accounting theory consist of three hypotheses: the bonus plan hypothesis, the debt/equity hypothesis and the political cost hypothesis. To explain and predict whether an organization would support or oppose a particular accounting method, these three key hypotheses in the positive accounting theory literature has frequently used. By using a different incentive, each of the three hypotheses tries to explain the use of earnings management. Consequently, each of these three hypotheses has the incentives or possibility of the use of earnings management. There is short explanation of those three hypotheses:

1. The bonus plan hypothesis

   “The bonus plan hypothesis states that managers of the firms with bonus plans are more likely to use accounting methods that increase or maximizes current period reported income. Such selection will presumably increase the present value of bonuses if the compensation committee of the board of directors does not adjust for the method chosen (Watts and Zimmerman, 1986). Because they choose the accounting methods, of which they profit the most, based on thi definition the assumption exists that managers behave opportunistic. The positive accounting theory states that all actions has based on self-interest. Managers will choose an action that will meet their own needs and desires the best.

2. Debt / equity hypothesis

   “The debt / equity hypothesis predicts the higher the firm’s debt / equity ratio, the more likely manager’s use accounting methods that increase income. The higher the debt / equity ratio, the closer the firms is to the constraints in the debt covenants. The tighter the covenants constraints, the greater the probability of a covenant violation and of incurring costs from technical default. Managers exercising discretion by choosing income increasing accounting methods, relax debt constraints and reduce the costs of technical default” (Watts and Zimmerman, 1986). When the debt / equity ratio increases the debt / equity hypothesis states that management will choose the accounting method that increase reported profit. The higher the debt / equity ratio, the closer the firm is to the constraints in the debt covenants. Management's incentive to adopt certain accounting method to relax debt constraints and reduce the costs of technical default can classify as earnings management.

3. Political cost hypothesis

   The political cost hypothesis predicts that large firms rather than small firms are more likely to use accounting choices that reduce reported profits. Size is a proxy variable for political attention. Underlying this hypothesis is the assumtion that is costly for the individuals to be informed about whether accounting profits really represent monopoly profits and to contract with others in the political process to enact laws and regulations that enhance their welfare. Consequently, rational individuals are less than fully informed. The political process is no different from the market process in that respect. Given the cost of information and monitoring, managers have incentive to exercise discretion over accounting profits and the parties in the political process settle for a rational amount of ex post opportunism (Watts and Zimmerman, 1986).

2.3 Earnings Management

2.3.1 Definition of Earnings Management

Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to 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, 1999). Prior studies provide some essential definitions of earnings management. First, Schipper (1989) defines earnings management as the purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain. Second, Scott (2012) defines earnings management as the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective. Agents have specific information through their expertise which is often costly to communicate to the principal. The contract's efficiency is reduced by this blocked communication and therefore the principal may seek ways to reduce or eliminate this blocked communication (Scott, 2012).

2.3.2 Motivations of Earnings Management

According to Scott (2012) stated several motivation that encourage why firms doing earnings management, there are:

1. Bonus plans

   Manager has net income information before it is reporting in the financial statement, in this condition outside party does not understand and read this report. For that, the managers will try to set the net earnings in order to maximized their bonus according to company compensation plans. There are two approaches that can be done by manager in controlling the earnings: (a) accruals control that consists of revenue, expenses in the loss calculation that is not impacting to cash flows, (b) accounting policy altering.

2. Debt covenant

   Debt covenant is an agreement to protect the lender from the manager acts against the interests of creditors. Several interest creditors are excessive dividends, additional loans, or allowing working capital and property owners are at a predetermined level, all of which lowering the security (or increasing risk) for existing creditors. This contract is based on positive accounting theory, the debt covenant hypothesis, which states the closer a company to breach debt covenants, managers tend to choose accounting procedures that can "move" the next period earnings to the current period.

3. Political motivation

   Political aspects cannot be separated from the company, especially large enterprises and strategic industries because of its activity involves the lives of many people. Several political motivations that encourage companies to do earnings management by lowering profits such as (a) to reduce the political expense and government oversight, (b) to reach the government simplicity and facility, for example, subsidies, protection from foreign competitors, and (c) to minimized the demand from labor union.

4. Taxation motivation

   Taxation is one of the main reasons why the company reduced reporting net income. For example, for inventories, company will choose LIFO accounting method that will results in the lowest net income rather than another methods.

5. CEO rotation

   Diverse motivations arise around the time of CEO turnover. For example, the CEO that is nearing the end of the assignment will make profit-maximizing strategy to increase the bonus and make a new CEO was very hard to achieve the level of profit. As well as CEOs who are less able to improve corporate performance will tend to maximize profits in order to prevent or cancel his dismissal.

6. Initial public offering (IPO)

   In essence, the first time a company that offers shares in the capital market has not possessed market prices. This company has a problem about how to establish the value of shares to be offered. Therefore, to bargain, the financial information contained in the prospectus is an excellent source of information. Analytical basis, net income information can be used as a signal to investors about the "value" of the company. So, this raises the possibility that the management company that is go public conduct earnings management to obtain a higher price on the shares.

7. Communicate the information to investors

   Rational investor will invest based on historical net income to predict net profit in the future. Managers who have information about the prospects of future net income could do earnings management that represent the best estimate of manager for the company's power to generate net income in the future. In addition, managers can use income smoothing strategy to communicate the strength of the company to generate consistent profits in the future.

2.3.3 Patterns of Earnings Management

Scott (2012) recognizes a variety of earnings management patterns:

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 occur during the period of the pressure at the time of organization or reorganization, such the turn of new CEO. Recognize the cost 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 Earnings Management Through Real Activities Manipulation

Roychowdury (2006) defines real activities manipulation as departures from normal operation practices, motivated by the desire of manager to mislead at least some stakeholders to believe in certain financial reporting goals have been met in the normal course of operations. According to Sanjaya (2012) real activities manipulation is a tool to manage earnings through the choice of changing the time or the structure of an operating, investing, and/or financial transaction to affect output accounting system. Managers also have the opportunity to manage earnings by manipulation of real activities.

There are three methods of real activities manipulation (Roychowdury, 2006):

1. Sales manipulation, that is, accelerating the timing of sales and/or generating additional unsustainable sales through increased price discounts or more lenient credit terms. Operating cash flow is a kind of activity from cash flow information that consists of firm operating activities. The method that is used to manipulate real activity through opearting cash flow is sales manipulation. Sales manipulation is correlated to how the manager try to increase the sales within the accounting period in order to increase the earnings to reach targeted earnings. Manager opportunistic action through the sales manipulation can be implemented by offering over-price discount of the product or giving the more lenient credit requirements. This strategy surely will increase the sales volume and current period

earnings. The increasing of sales volume not only leads in increasing the earnings of going period, but also leads in decreasing the cash flow beause of the small cash inflow due to the credit sales and sales discount. Therefore, the activity of sales manipulation tends to decrease current period operating cash flow rather than normal level of sales and abnormal growth of receivable.

2. Reduction of discretionary expenditures. Discretionary expenses are expenses that arise from the discretion of managers and not correlated with accrual relationship with the output, such advertising, R&D, and also sales, general, and administration expense. Because discretionary expenses are subject to management's judgment, they can be used to manage earnings. A firm can reduces and decreases the discretionary expenditures that tends in increasing the going period earnings and current period cash flow if a firm generally pays that expenditures/expenses in cash. This strategy will increase the earnings and current period cash flow with the risk of decreasing future period cash flow.
3. Overproduction, or increasing to report lower cost of goods sold. Production cost is all the costs that are paid in order to produce the goods. Method that will be used to do the real activities through the production cost is overproduction. The manager of the company can produce more than the needs in assuming that the higher production rate that leads in lowering the product fixed cost per unit. This strategy will reduce the cost of goods sold and increasing the operating profit.

2.5 Good Corporate Governance

According to Cadbury (2001) corporate governance is concerned with holding the balance between economic and social goals, and between individual and communal goals. The governance framework is there to encourage efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align nearly as possible the interest of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for the state is to strengthen their economies and discourage fraud and mismanagement. Then, prior study stated that corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs (corporate insiders) on one hand, and those who invest resources in corporations, on the other (OECD, 2001)

There are five basic principles of good corporate governance according to the Organization for Economic Corporation and Development (OECD):

1. Fairness

   Emphasizes on the principle of fairness means giving the treatment and guarantees the same rights to both the minority and majority shareholders. It is important to protect the interests of shareholders and fraudulent practices of insider trading practices carried out by an agent / manager. This principle is intended to overcome the constraint arising from the existence of a contractual relationship between the owner and manager between the two parties that have different interests.

2. Accountability

This principle related to a system that controls the relationship between the control units in the company. Accountability carried out in the presence of the commissioners, board of directors, independent directors and audit committee. Accountability necessary to overcome the agency problems that arise between shareholders and directors and its control by the commissioner. Practices to do with empowering the commissioners, control of management, and a clear limitation of power on the board of directors.

3. Transparency

Basic principles of transparency associated with the quality of the information presented by the company. This principle is realized by developing a standards-based accounting system with good practice to ensure financial information and disclosure quality and the development of management information systems to ensure performance measurement. This principle calls for transparency in the decision making process and transparency in the presentation of information that owned by company.

4. Responsibility

Responsibility is defined as a corporate responsibility as members of society to meet the applicable laws and regulations as well as the fulfillment of social needs. This principle emphasizes the existence of a clear system to regulate the mechanism of corporate responsibility to shareholders and other parties interested in the efforts to realize the goals to be used for good corporate governance.

5. Independency

   To implement the principal of good corporate governance in a company, it is required that a company independently run by its members. This condition is important to prevent a party that will dominate and outside party intervention.

The benefits of implementing corporate governance according to Forum for corporate governance in Indonesia (2002):

1. Improve corporate performance through the creation process of making better decisions, improve operational efficiencies and further improve service to stakeholders
2. Facilitate the financing proceeds are less expensive and are not rigid (due to the trust factor), which in turn increase corporate value
3. Restore the confidence of investors to invest in Indonesia
4. Shareholders will be satisfied with the performance of the company as well as to increase shareholder's value. Especially for SOEs will increase the acceptance of the results of privatization, especially the state budget

According to World Bank (1999), there are two mechanisms to control corporate governance, internal mechanism and external mechanism. Internal mechanism in the components that is directly correlated with the decision maker in the company (shareholders, board of commision, board of directors, and management). Moreover, external mechanism are standard, laws and regulations, financial sectors and markets.

2.6 Firm Size

Company size is a measurement of the amount of company assets whether it is small or large, the characteristics of the company in terms of market segments those are run by the company in its operations. Firm size shows the amount of experience and ability that indicates the growth of a company and the ability to manage investment risk level given the shareholders to increase their ability.

Watt and Zimmerman (1978) assume that size is very sensitive to the behavior of companies in reporting earnings. Medium and large companies have more intense pressure from its stakeholders. That the performance of the company in accordance with the expectations of the investors as compared to small firms.

On the other hand, Kim et al. (2013) suggests a different empirical evidence that all sizes of companies reported positive earnings always proven to avoid lossess earnings or earnings decreases. Whereas according Sujana (2004), a company that has total assets of small companies shows that the potential to earnings management practices, otherwise the company which has total assets of great shows that the company has reached a stage of maturity and tend not to practice earnings management.

2.7 Existing Literature

Researcher	**Study**	**Result**
Guna and Herawaty (2010)	Examine the influence of good corporate governance mechanism, auditor's independency, leverage, and audit quality, profitability and company's size on the earnings management practices in manufacturing companies listed in Indonesia Stock Exchange	Indicated that leverage, audit quality and profitability had influence on earnings management practices. It means that leverage, audit quality by audit firms size and profit or loss that was reported by the management will motivate earnings management practices
Boediono (2005)	Explains phenomenas of the financial reporting audit quality, especially earnings responsiveness that is determined by factors of earnings management and corporate governance mechanism,	(1.a) Simultaneouly the effect of mechanism of institutional ownership, managerial ownership and composition of board of commisioners on earnings management was weak; (1.b) Partially the effect of

	namely the mechanism of institutional ownership, managerial ownership, managerial ownership and composition of board commisioner	mechanism of institutional ownership, managerial ownership and composition of board of commisioner on earnings management was semi strong, weak, and very weak respectively. (2.a) Simultaneously the effect of mechanism of institutional ownership, managerial ownership, composition of board of commisioner and earnings management on earnings quality was semi strong; (2.b) Partially the effect of mechanism of institutional ownership, managerial ownership and composition of board of commisioner and earnings management quality was weak and very weak respectively

Jati (2008)	Examines the impact of corporate governance structure to company performance	There is a significant impact among the variables of corporate governance structure to the company perfromace that is measured by ROA (Return on Asset) and found that there is no significant imapct among the variables of corporate governance structure to the company performance that is measure by ROE
Ujiyantho and Pramuka (2007)	Examines the influence of corporate governance mechanism, namely institutional ownership, managerial ownership, presence of independent of director and size of director to earnings management	(1) Institutional ownership had no significant influence to earnings management (2) Managerial ownership had negative significant influence to earnings management (3) Presence of

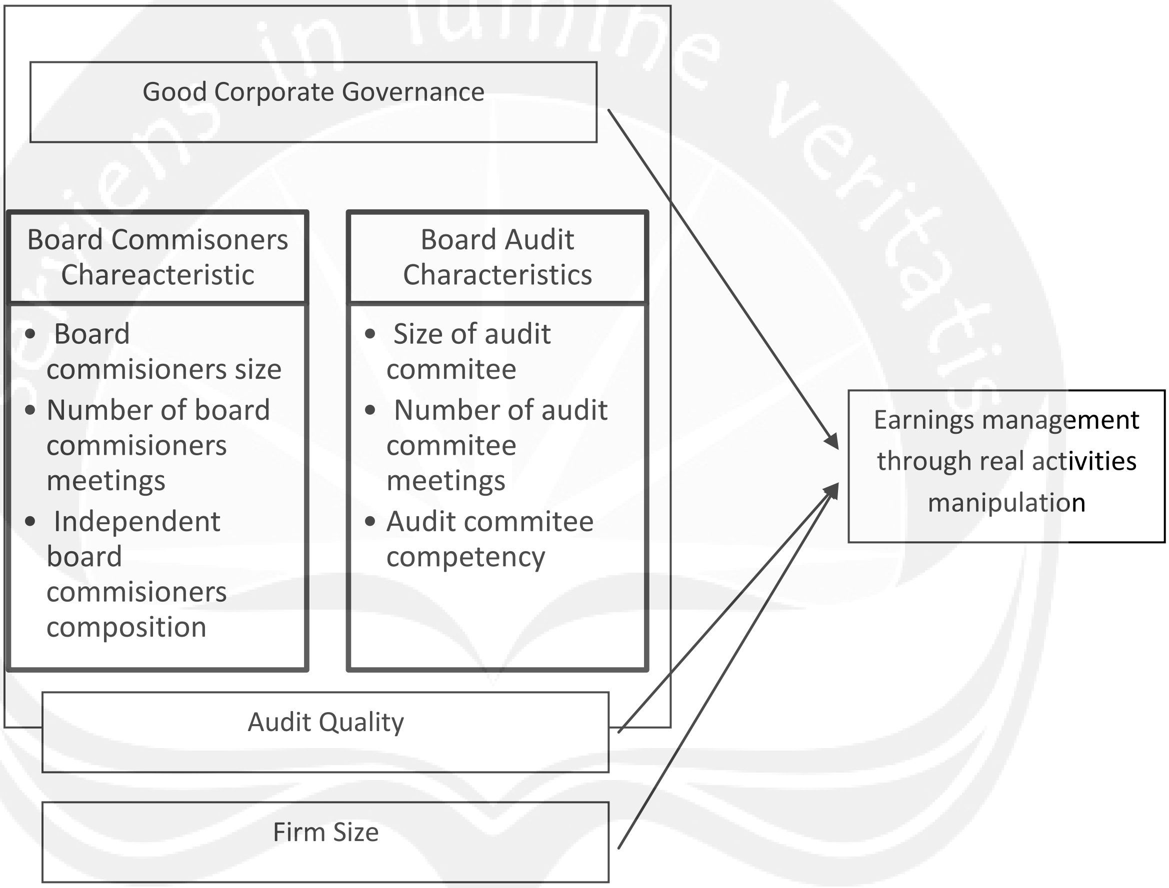
		independent of director had positive significant influence to earnings management (4) Size of director had no significant influence to earnings management (5) Simultaneously of institutional ownership, managerial ownership, presence of independent of director and size of director had significant influence to earnings management, and (6) Earnings management had no significant influence

		to financial performance
Zang (2012)	Studied whether managers use real activities manipulation and accrual-based earnings management as subtitutes in managing earnings	From documented large-sample evidence consistent with managers using real activites manipulation and accrual-based earnings management as subtitutes
Luhgiatno (2008)	Examines whether corporate governance has the impact on preventing earnings management	Thre result of this study is, one way in preventing earnings management is through the implementation of effevtive corporate governance in the company
Sanjanya and Saragih (2012)	Examines the effect of real activities manipulation on accrual earnings management: the case in Indonesia Stock Exchange (IDX)	The result of this study support the research hypothesis that real activities manipulation positively influence accrual earnings management. The higher the real activities manipulation effects, the higher the accruals earnings

		management at the end of period.

2.8 Logic Framework

To describe the effect of corporate governance on earnings management through real activities manipulation, then the following logical framework:



2.9 Hypothesis Development

2.9.1 Board commisioners size and real activities manipulation

Board commissioner is crucial part of corporate organization, connecting between owner party or stockholder and management party. Activities of board commisioner consist of giving directions and supervisions. Board commissioner is the central of corporate governance who have duty to assure the performance strategy of company, supervise management is managing the company, and oblige the performance of accountability. The function of board commisioner are to perform the mechanism of supervision and to advice the management in running the good corporate governance, including supervising the financial reporting of the company, so the interests of all stocks holder are protected.

As discussed in agency theory, earnings management can be an act of manipulation by managers who in turn will impact on the value of earnings in the financial statements that are irrelevant or biased in order to mislead the users. As a supervisor or party monitoring company, of course board of commisioner has an important role in order to run the company's activities in accordance with applicable regulations. The effect of board commissioner size on earnings management is mixed though it has significant effect on firm performance (Pierce and Zahra, 1992).

According to Dalton et al. (1999) and Bradbury et al. (2006) larger board commissioner size will provide better business management that will limit the level of earnings management. Larger boards are also claimed to have information and expertise advantage over smaller boards (Pierce and Zahra, 1992). In bankruptcy context, According to Chaganti et al. (2006) failed firms are found to have smaller boards than survivor.

Prior studies in Indonesia, Akhtaruddin (2009) stated that the larger the board commisioner size, the composition of experience and expertise that are owned by a board of commissioners to increase, so will create a better monitoring activity. Number of commissioners should be adapted to the complexity of the company with regard to its effectiveness in decision making. Thus, the practice is expected to be reduced due to chance of earnings management, where the the possibility of managers to do financial misrepresentation can be reduced.

H1 : Board commisioners size negatively impact real activities manipulation

2.9.2 The number of meetings of board commisioners and real activities manipulation

In agency theory assumes that humans have a limited intellect (bounded rationally), as well as the board of commissioners. In carrying out his duties, takes the role of some of the commissioners that coordinate with each other and exchange ideas. For it held regular meetings to evaluate the policies taken by the dean of directors and its implementation (Waryanto, 2010). In communication and coordination among the members of the board of commissioners will discuss the company's direction and strategy, evaluation of policies that have been taken by management, as well as addressing the problem of interest conflict (FGCI, 2002). With more frequent dean commissioner meetings, oversight mechanisms are expected to do more effective. The increasing of effective supervision is expected to be able to restrict the opportunity of managers to manipulate the financial report so that the practice of earnings management in the enterprise can be minimized.

There are many prior studies conclude that the meeting of coard commisioner is an essential part in good corporate governance implementation. Board meeting is defined here as the frequency of board meetings in a year. This clarificationis necessary because Xie et al. (2003) argue that boards that meet more often could reduce earnings management activity as they are able to allocate more time on issues such as earnings management while boards that seldom meet are unlikely to focus on these issues. They found evidence of a negative association between a lower level of earnings management and the meeting frequency of the board and suggest that board activity provides effective monitoring mechanisms of corporate financial reporting.

Conger et al. (1998) suggest that the number of times a board meets is an important resource in improving the effectiveness of a board. The results of Chen et al. (2005) in China showed that the frequency of meeting of board members in one year affect the fraud in financial reporting. The number of meetings held by the board of commissioners is expected to influence the practice of earnings management through real activities manipulation. Thus the commissioners should have more intensive meetings in order to evaluate and monitor the performance of the company. With the performance evaluation and monitoring are routinely expected to make it difficult for managers to manipulate financial data so that the practice of earnings management through real activities manipulation can be minimized.

H 2 : Number of meetings of board commisioners negatively impact real activities manipulation

2.9.3 Independent board commisioners composition and real activities manipulation

Board composition refers to the number of independent commissioners in comparison with the total of the board of commissioners' members. The board composition must enable an effective, accurate, and fast decision making. Independent commissioners have the task to ensure a balanced decision-making, especially to protect minority stockholders and other relevant parties.

One of discussion in agency theory that talk about the core agency relationship is the separation of function in a company. This is a result of the action of earnings mangement action. Separation of function between the principal as the owner of the company with the agent as a manager being the opportunity for managers to do fraud on the financial statements for his personal welfare.

Board of commisioner effectiveness as balancing power of CEO is heavily affected by their independency. Agency theory supports the view that to improve board of commissioner independency, the board shall be dominated by outside directors. The presence of outside directors is needed to monitor and control directors' actions (Jensen and Meckling, 1976). Non executive directors will affect decision making to improve firms' performance (Zahra and Pearce, 1998). Thus management is forced to take responsibility and consider the interest of shareholders or stake-holders.

The role of the independent commisioners who can run their task in monitoring a company without any influence of other party is needed. The effective supervision of independent commisioner would reduce the possibility of arising the agency problem. With supervision conducted by the independent commissioner will make a manager or agent to be careful and transparent in running the company that will create a climate more objective in order to reconcile the differences between the interests of owners and management.

Fama and Jensen (1983) state that independent commissioner could help overcoming potential conflict between managers and control and provide consideration to management of the firm. According to Cornett et al. (2006) Independent commissioner is in good position for monitoring process so to ascertain that good corporate government is in place, which in turn could reduce the use of discretionary accruals. Boediono (2005), Veronika and Utama (2005), Ujiyantho (2007) found evidence that the independent commissioner has a positive effect on earnings management. Chtourou et al. (2001) find that independent board will constrain earnings management activity.

In Indonesia (Siregar and Utama, 2008), system that exists in Indonesian's company uses two tier system that consist of commissary board and direction board. The function of commissary board is to watch over the actions of direction board. To prevent loss of minor shareholder, BAPEPAM insist that 30% of commissary board must be independent and major shareholders. Thus the presence of independent board commisioners is expected to affect earnings management practices through real activity manipulation. The increasing of board commisioner independency, the greater the dean may influence decision-making in order to align the various conflicts of interest so that the practice of earnings management through real activities manipulation more can be minimized

H 3 : Independent board of commisioners composition negatively impact real activities manipulation

2.9.4 Audit commitee size and real activities manipulation

One of the agency problem discussed in agency theory is the emergence of an information asymmetry between the principal parties to the agent. The existence of an audit committee is essential for the management of the company. The audit committee is considered as a link between the shareholders and the board of commissioners with management in dealing with control problems. With the audit committee as a governance mechanism corporate is able to ensure the implementation of corporate practices more equitable and transparent.

The audit committee is a committee in charge of the company that act as company's internal audit. Under the Circular, SE-008/BEJ/12-2001, audit committee membership consists of at least three people, including the chairman of the audit committee. The committee members from the commissioner of only one person, members from the commissioner is independent listed companies as well as a chairman of the audit committee. Other members who are not members of an independent commissioner should come from an independent external party. Therefore, their existence should improve the practice of good corporate governance in the firm, which in turn will reduce information asymmetry and opportunistic earnings management

An audit committee plays an important monitoring role to assure the quality of financial reporting and corporate accountability (Carcello and Neal, 2000). As a liaison between the external auditor and the board, an audit committee bridges the information asymmetry between them, facilitates the monitoring process (Klein, 1998), and enhances the independence of an auditor from management (Mautz and Newmann, 1977). A properly functioning audit committee is thus critical in enhancing effective oversight of the financial reporting process and achieving high quality financial controls.

Klein (2002) also found out that the existence of audit committee will reduce the earning management practices. In Indonesia, research done by Siregar and Utama (2008) reveal that there are negative relation between discretionary accrual with the audit committee. Klein (2002) states that company that has an audit committee can prevent earning management practices done by the management. Jaggi and Leung (2007) research says the same thing. Audit committee can reduce earning management practice in a company with a concentrated owner. Lin (2006) did a research to test the effect of audit committee existence with earning management shows a negative effect, means audit committee can reduce earnings management practice done by the management.

Audit committee composition is an important factor in effective monitoring (Beasley, 1996; Carcello and Neal, 2000), and therefore the composition of an audit committee may have a direct role in constraining earnings management. Audit committee composition has been the focus of many governance reform efforts, and all companies listed on major stock exchanges such as NYSE and NASDAQ must now maintain an audit committee with at least three solely independent directors, except in certain restricted circumstances (e.g., BRC, 1999; NASD, 1999; SEC, 1999; SEC, 2003). Kalbers and Fogarty (1993) propose that audit committee effectiveness is perceived as a function of audit committee power.

Larger audit committees, with legitimate power delegated by boards, are expected to contribute to the effectiveness of the committee, given audit committee effectiveness as a function of audit committee power (Kalbers and Fogarty, 1993). A larger audit committee with increased organizational status and power delegated by the board of directors is thus more likely to be recognized as an authoritative body by the management and the external and internal auditors. We thus expect that a larger audit committee is likely to be a more effective mechanism, since audit committee members have increased responsibilities and organizational status and power for their monitoring roles after recent governance reform efforts.

H 4 : Audit commitee size negatively impact real activities manipulation.

2.9.5 The number of audit committee meetings and real activities manipulation

As same as with the board commisioners in relation with assumption in agency theory where human have limited intellect (bounded rationally) the effectiveness of financial and internal control also requires regular meetings. Forum for Corporate Governance in Indonesia (FGCI) requires the audit committee to hold meetings three to four times a year. This is supported by best practices, they suggest that it should be three or four meetings a year (Cadbury Committee, 1992; Price Waterhouse, 1993; KPMG, 1999). The frequency of these meetings should be clearly structured and well controlled by the chairman of the committee.

Audit committee meeting is defined here as the frequency of audit committee meetings in a year. To be specific, following Xie et al. (2003) audit committees that have members with adequate expertise and skills to understand financial reporting details and meet more often could reduce earnings management activity as they are able to allocate more time on issues such as earnings management while audit committee that seldom meet are unlikely to focus on these issues.

According to Anggarini (2010) by doing the periodically meeting, audit commitee can prevent and reduce the possibility of mistakes occured in management decision making. Company internal control activity is held periodically and structurized that will easily detect and solve the problems occured by management. Another prior study that support this research is the evidence found by Xie et al. (2003) the number of audit committee meetings is negatively associated with discretionary current accruals, suggesting that audit committee meeting frequency is an important factor in constraining the propensity of managers to engage in earnings management.

Effective audit committees meet regularly to ensure that the financial reporting process is functioning properly, and therefore a well-functioning and active audit committee may be able to prevent earnings management. Menon and Williams (1994) find that audit committee effectiveness can be measured by the number of audit committee meetings. An active audit committee is more likely to influence managements' and/or boards' decisions.

It means that the more meeting held by audit commitee will lead for more transparant of earnings information. As to this, the more often a meeting held, the more effective controlling function, so that it is expected can restrict the deviation behavior by manager and minimized the earnings management through real activities manipulation.

H 5 : The number of audit committee meetings neagtively impact real activities manipulation

2.9.6 Audit commitee competency on real activities manipulation

Because of their responsibility for overseeing internal control and financial reporting, good governance dictates that audit committee members should possess a certain level of financial competencies. Thus the BRC (1999) recommends that each member of the audit committee should be or become financially literate and that at least one member should have accounting or related financial management expertise, where “expertise” is defined as “past” employment experience in finance or accounting, requisite proffesional certification in accounting, or any other comparable experience or background which result in the individual’s financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities.

Audit committee members who can cover the financial and accounting will be professionally and quickly adapt to change and innovate (Hambrick and Mason, 1984). Personal existence qualifies as an audit committee member is expected to adopt the accounting standards with a high level of achievement, can provide assistance in a supervisory role, and tried hard to image and better corporate performance (Anggarini, 2010).

This recommendation is supported by various empirical and experimental studies such as McMullen and Raghunandan (1996) who find that firms subject to SEC enforcement actions or restating their quarterly reports are less likely to have CPAs on their audit committee. Using an experimental case, DeZoort and Salterio (2001) find that the accounting experience of audit committee members as well as their knowledge of auditing are positively associated with the likelihood that they will support the auditor in an auditor-corporate management dispute. These prior studies and reserach findings suggest that the financial competence of audit committee members decrease the likelihood of earnings management.

In relation to the practice of earnings management, the audit committee is competent and capable of checking and analyzing financial information so as to detect any indication of earnings management practices through real activities manipulation. Thus the audit committee with a good competence can improve the quality of supervision that the practice of earnings management through real activities manipulation undertaken earnings management can be minimized.

H 6 : Audit committee competency negatively impact real activities manipulation

2.9.7 Audit quality and real activities manipulation

Based on agency theory, which assumes that man is always self-interest, then the presence of a third party that is independent external auditor as a mediator of the relationship between principal and agent is very required. The existence of the external auditors will be about providing independent and professional assessment over the reliability and fairness of the presentation of the financial report integration. The external auditors may be mechanisms to control management to financial management information that is reliably present and free from fraudulent accounting practices. This role can be achieved if the external auditor about providing a quality audit services (Nuryaman, 2008). In addition, investors will be more inclined to believe the accounting data generated from high quality audit (Satiti, 2010).

Zhou and Elder (2001) states that public accounting firm industry specialization is the dimension of audit quality because the auditor's knowledge and experience of the industry is one of the elements of auditor expertise. Public accounting firm that has a deeper understanding of the special audit risk in the industry.

Audit quality on audit committee plays an important role in monitoring management to protect shareholders' interest (Hasan and Ahmed, 2012). Audit quality according to DeAngelo (1981) is the probability an auditor will (1) discover fraud in accounting system and (2) 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 studies also report that good audit quality constrains opportunistic earnings management (Becker et al. 1998, Francis et al. 1999). Audit quality is the important thing that needs to be considered by the company, where the companies whose audit done by Big 4 are considered have high audit quality and the companies whose audit done by Non Big 4 are considered have low audit quality.

According to Susiana and Herawaty (2007) KAP (Public Accounting Firm) Big 4 in Indonesia are (1) Price Water House Coopers (PWC), with Indonesian partner are Haryanto Sahari and Partner; (2) Deloitte Touche Tohmatsu, with Indonesian partner are Osman, Ramli, Satrio and Partner; (3) Klynveld Peat Marwick Goerdeler (KPMG) International, with Indonesian partner are Siddharta and Widjaja; (4) Ernst and Young (EY), with Indonesian partner are Prasetio, Sarwoko and Sandjaja.

Firms audited by Big 4 audit firms reported less discretionary accruals compares to firms audited by smaller firms. This finding is consistent with several previous studies. Literature mostly related to the present study includes Becket et al. (1998), Maydew and Sparks (1999), Francis and Krishnan (1999), Chang (2001), Vander Bauwhede et al. (2003) who argue that lower levels of discretionary accruals are associated with higher quality audits. Chang (2001) concluded that higher quality auditors reduce more opportunistic accruals. Fernando et al. (2010) argue that Big 4 auditors will be able to provide a better quality than non-Big 4 audit firms.

Zhou and Elder (2001) states that public accounting firm industry specialization is the dimension of audit quality because the auditor's knowledge and experience of the industry is one of the elements of auditor expertise. Public accounting firm that has a deeper understanding of the special audit risk in the industry.

A deeper understanding of an industry will increase material misstatement found. Specialist auditors are expected to detect errors in financial reporting and the possibility of manipulation of financial data. Qualified public accounting firm in a particular industry is expected to limit the practice of earnings management through real activities manipulation.

H 7 : Audit quality negatively impact real activity manipulation