

CHAPTER I

INTRODUCTION

In this chapter, the researcher elaborates six major underlying issues, namely background of the study, research limitations, problem statement, research objective, research benefit, and thesis structure. The introduction is intended to build the main reasons for conducting the research.

1.1. Research Background

Earnings management is the way managers manipulate financial reports in order to meet certain target (Scott, 2011) and there are evidences from Kothari (2002), Healy & Wahlen (1998), and Fields et al (2001) about managers who manipulate earnings in companies. There are four patterns of earnings management; *taking a bath*, *income minimization*, *income maximization*, and *income smoothing*. The purposes or motivations of earnings management are to gain bonus purposes, covenant purposes, implicit contracting purposes, to meet investors' earnings expectations, to maintain companies' reputation, or to prepare initial public offerings (IPO).

There are two ways to do earnings management, first is using accrual-based manipulation and second is using real activities manipulation. Earnings management through accrual-based manipulation is explained as manipulation of earnings by choosing specific principles, bases,

conventions, rules, and practices while preparing and presenting financial reports.

According to Roychowdhury (2006: 336), “Earnings management through real activities is defined as management actions that deviate from normal business practices in order to meet certain purposes.” The management’s objective of managing earnings through real activities is to mislead stakeholders into believing certain financial reporting goals have been met in the normal course of operations at least for a short time, so that the companies will receive better terms from stakeholder and to enjoy a significant share price increased.

Managing earnings through real activities has benefits than depends only on accrual-based earnings management alone. First, accrual manipulation is more likely to draw auditor or regulator attention than real decisions about pricing and production. Second, accrual manipulation has a risk because if the reported income falls below the threshold and all accrual based strategy is exhausted, managers has no option (Bruns and Merchant, 1990 and Graham et al, 2005). The reason managers will not have choice if the accrual based strategy exhausted is real activities cannot be adjusted at or after the end of fiscal period (Cohen and Zarowin, 2008). However, there is a possibility that companies can keep both of the manipulation methods. The reason is because keeping both of the manipulation methods will make the companies have a possibility to

manage earnings using accrual-based and real activities substantially or simultaneously (Zang, 2006).

Roychowdhury (2006) points out that variables used to detect earnings management through real activities manipulation are cash flow from operation, discretionary expenditure, and production costs. Therefore, in this research, the researcher also use those variables to detect real activities manipulation.

In Indonesia, there are several research on earnings management through real activities that state differently about the results of the researches. Annisaa'rahman (2007), Agmarina et al (2011), Nurmawati (2012), and Dura (2009) are the examples of studies that cannot prove the use of earnings management through real activities in Indonesia. On the other hand, Oktorina (2008), Sahabu (2009), Sari (2008), Andayani (2008), Vita (2009), and Aprilia (2010) find that companies in Indonesia is manage earnings through real activities. This thesis is made in order to find a consistent result of earnings management through real activities from Indonesian listed manufacturing companies using simplification of Roychowdhury's research (2006) as its based.

1.2. Problem Statement

The problem of the research is stated as follows:

Does the listed companies in Indonesia do earnings management through manipulation of real activities?

1.3. Research Scope

The variables that are used in this study are cash flow from operation (CFO), production costs which are the sum of cost of goods sold (COGS) and change in inventory, and discretionary expenditure. Discretionary expenditure is the sum of advertising expenses, research and development (R&D) expenses, and selling, general and administrative (SG&A) expenses. The normal estimation models and regression formula is taken from Roychowdhury's (2006) research. In relation to the estimation models and regression formula, data from manufacturing companies is best to use. The data is taken from Indonesia Stock Exchange website from 2009 to 2011.

1.4. Research Objective

The objective of the study is to answer question presented in the problem statement. The answer to the question covers the information about earnings management through manipulation of real activities that affect cash flow from operations on listed manufacturing companies in Indonesia from 2009 to 2011.

1.5. Research Benefits

a. For students

This paper may give additional knowledge about accounting choices that there is a possibility companies will manage their earnings not only using accrual-based manipulation but also using real activities.

b. For researchers

This paper gives the researchers knowledge about another strategy that may be used in earnings management and how the companies manipulate certain variables to meet their target. This paper also gives explanation on how to detect earnings management through real activities using Rochowdhury's estimation models.

1.6. Thesis Structure

This research is divided into five chapters, which are:

CHAPTER 1 INTRODUCTION

This chapter consists of the background of the research, the problem statement and objectives of the research, and the benefit of the research.

CHAPTER 2 THEORITICAL BACKGROUND AND HYPOTHESES

DEVELOPMENT

This chapter explains further about theories that support the study, previous research, and hypothesis development.

CHAPTER 3 RESEARCH METHOD

This chapter consists of sample, data resources, and method of data analysis which are used in this research.

CHAPTER 4 DATA ANALYSIS

This chapter explains the analysis of the data to reach the conclusions.

CHAPTER 5 CONCLUSIONS

This chapter consists of conclusions, research limitations, and suggestion for further research.

