CHAPTER 1

INTRODUCTION

1.1 Background

The financial reporting has an objective to summarize financial performance of the company periodically. Therefore, financial report will provide important information about the progress that has been achieved by the company. Financial reporting helps the best performer firms in the economy to distinguish them from poor performers and facilitate efficient resource allocation and stewardship decisions by stakeholders. One indicator from the financial reporting that commonly use to assess performance is earnings. Earnings has important role as the measurement of the company's performance. Stakeholders used earnings in measuring management's performance, determining executive compensation, assessing firms' future prospects to make resource allocations, and firm valuation decisions (Xu et.al., 2007). Beside all of that, earnings also can be one factor for fluctuation of stock prices in the stock market. Therefore, managers are keen to show better reported earnings in their financial report.

In order to achieve the targeted income or to show better reported earnings in their financial report, even though the company doesn't performing really good, commonly managers are tend to manipulate earnings (Graham, 2005). According to Scott (2000) there are some motivations of earnings management, such as: bonus purposes, political motivation, taxation motivation, Chief Executive Officer (CEO) replacement, Initial Public Offering (IPO) and the importance of giving company's information to affiliated parties. Those motivations of earnings management could be possibly executed by the manager for either personal or companies benefit purposes.

Any specific activity form the manager that attempt to manipulate earnings whether through applying some accounting principles or by real activities can be classified as earnings management. Along with its development, there were lot of researcher doing research about earnings management and its impact for the company. Healy and Wahlen (1999) brought a definition of earnings management :

"Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlaying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."

The definition above is focusing on the accrual earnings management which exploiting the accounting discretion under GAAP or even IFRS. On the other hand, real earnings management involves managers to alter financial report by adjusting the scale and timing of business activities. While the accrual earnings management has been the primary research focus, recently, there also emerge some of real earnings management research.

Research from Cohen, D., A .Dey, and T. Lys (2008) shows that years after the passage of SOX incident, accrual-based earnings management was declined significantly. Then managers decided to shift from accrual-based to real-based earnings management even though it will be more costly in the long run, but it is more likely harder to be detected (Kothari et. al .2012). For some reasons, this research is also will focus on the real earnings management.

There are three common real earnings management technique that could be possibly done by the manager. First, real earnings management is executed through the cashflow from operation, where the manager manipulating sales through giving temporary price discount and more lenient credit terms to increase sales. Second, real earnings management technique from reduction cost of production. It is done by increasing inventory through massive production in a period, thus, the overhead cost will be allocated to big amount of units. Therefore, the fixed cost of each unit will be lower and so does for the cost of goods sold. Third, real earnings management by reduction of discretionary expenditure such as advertising expense, research and development expense, sales expense, general and administrative expense. This technique is done when those discretionary expenditures cannot provide short term earnings instantly.

Real earnings management that has been done by the manager will give direct impact on decreasing the ability of the financial report in predicting the future profitability of the company. Since the financial report is the source of information for the investor to make investment decision, then it can possibly mislead them. The future profitability of the company is one of the measurement tools that used by investor to understand the potential of a company in generating profit for the future through wealth management. According to Subramanyanm (1996) one of the measurement of future profitability can be done by calculating by the company's future operating cashflow.

Research from Gunny (2010) and Shue et. al (2013) found that firms engaging in REM will have a better one year ahead industry adjusted return on assets relative to firms that do not engage in REM. In contrast, research from Tabassum et.al (2013) shows that real activities manipulation and future financial performance have negative relationship. Firms that engaged in real activities manipulation have poor and low earnings in the future.

This paper will contributes to the literature and research that related with earnings management. Following the previous research from Graham et. al. (2005) ,Gunny (2010) and Tabassum et. Al. (2013), this paper will focus in three types of real earnings manipulation and investigate the consequences of those kind of earnings management. .Even though there are lot of research documenting if real manipulation occurs in many condition, but there are still little evidence of the effect of the real manipulation on subsequent companies' future operating future cash flows.

1.2 Problem Statement

Earnings is one important financial information for the investor. Therefore, management as the source of information from the company have to provide those kind of information fairly and representing the company's financial performance during the period. However, there are lot of literature research about earnings management demonstrating if managers misrepresent the company's financial information in objective to skewing the firm's stock market valuation upward. Some research also prove if managers try to attempt earnings manipulation at the timing of Seasoned Equity Offerings to maximize the process (Kothari et.al. 2012).

The year post SOX, managers tend to shift earnings management from accrual based to real based earnings manipulation (Cohen et al. 2007). Roychowdhury (2006) also explains that managers shift from the accrual to real activity earnings management because of: First, accrual manipulation has possibility to attract auditor or regulatory scrutiny compared with real decisions. Second, the risk is much higher if managers just depend only on accrual earnings management. It is because if the final realization targeted earnings is not reached or the accruals manipulation is not sufficient enough to cover the deficit, then can be concluded if the managers performance is not good enough in that period. Hence, the manager cannot get compensation from the contract or even increase the chance of being fired. Therefore, real activity earnings manipulation is more preferable and can be done along in the operation period, and also it may be the most save way for managers to achieve the targeted earnings.

The real earnings manipulation that executed by the managers definitely will give effect to the companies financial performance. Even though it is more likely to give benefits in the short term, but actually it will also possibly decline the company's financial performance in the future. The indicator of the financial performance that used in this research is operating cash flows. Therefore, the problem statement in this research is:

“Whether real earnings management activities has negative impact on the future operating cash flows of the company? “

1.3 Objectives of the Research

This research has purpose to empirically study the relationship between real earnings management toward companies' future performance. This research also will prove if the companies which practicing real earnings manipulation will have high short term performance, but low performance in the future because of deviating from the optimal normal operating decision compared to companies that don't engage in real earnings management.

1.4 Contributions of the Research

1.4.1 For Academics

This research can be the literature and give the information related to real earnings management in Indonesia. It's known that there are just little research finding the impact of real earnings manipulation on companies future performance in Indonesia.

1.4.2 For Practitioners

This research can be the source of information about real earnings manipulation and its effect to the company's future performance. This kind of information will help the stakeholders in a company when related with decision making process.

1.4.3 For Researcher

The result from this research can be the reference for other researcher who wants to do same research area or develop broader new ideas that related with this kind of topic.

1.5 Thesis Structure

This research is divided into 5 chapters, which are:

CHAPTER 1 INTRODUCTION

This chapter consist of the background of the research, problem statement, the objectives of the research, the contribution of the research and the thesis structure.

CHAPTER 2 THEORITICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

This chapter further explains theoretically about earnings management, earnings management technique, real earnings management, cash flow and cash flow from operation. In the end of this chapter, the development of the hypothesis will be described using theory and former research.

CHAPTER 3 RESEARCH METHOD

This chapter consist of the scope of sample selection, data collection method, variables description which includes independent variable, dependent variable, moderating variable and control variable and also data analysis method that used in this study

CHAPTER 4 DATA ANALYSIS

This chapter contains the result and analysis from several tests includes normality test, multicollinearity test, heteroscedasticity test, autocorrelation test and hypothesis test. Those test aims to provide reliable evidence regarding the finding of this research

CHAPTER 5 CONCLUSION AND LIMITATION

This chapter consist of the conclusion from the finding of this study, research limitation and the suggestion for further research.