CHAPTER II

LITERATURE REVIEWS AND HYPOTHESES DEVELOPMENT

2.1 Goodwill

According to IAS 38, an intangible asset is an identifiable non-monetary asset without physical substance. Intangible assets could be generated from the entities' activity. From IAS 38, it is stated that:

> "Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights."

Indonesian PSAK 10 (Revision 2010) as in accordance with IFRS 3 Business Combinations is stating that if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. If an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset. In accordance with this IFRS 3 (as revised in 2008), an acquirer recognizes at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognized by the acquiree before the business combination. This means that the acquirer recognizes as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset.

Thus, it is clearly stated that goodwill is one of the example of intangible assets. In paragraph 11, it is stated that:

"The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognized in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements."

Thus in brief, goodwill as an intangible asset is an identifiable non-monetary asset without physical substance which has future economic benefit and should be controlled. Goodwill is the difference between the cost of the purchase and the fair value of the net assets and it could arise in two different ways: (1) internally generated or; (2) acquired as part of the acquisition of another company (business combination). Goodwill shows up in the financial statements only if an acquisition has occurred. Internally generated goodwill is not recognized.

In Indonesia, the treatment for goodwill has been shifted from amortization to annual impairment test. Before 2011, accounting for goodwill was regulated by PSAK 48 requiring that goodwill arising from acquisition to be recognized and amortized on a systematic basis over its useful life.

2.1.1 Accounting for Goodwill

Goodwill is an intangible asset and falls under the regulation of IAS 38. Paragraph 89 describes that accounting for an intangible assets is based on its useful life. It makes a distinction between intangible assets with a finite or indefinite life (IFRS 2008, par 89). This difference is important for the method of measurement

of intangible assets. The lifetime for goodwill is difficult to reliably predict, and would be treated as an asset with an indefinite useful lifetime. Following paragraphs 107 and 108, IAS 36 Impairment of Assets is then used to apply the impairment method, as the amortization of goodwill is explicitly prohibited (IFRS 2008).

The objective of IAS 36 Impairment of assets is to describe an impairment test. The Standard prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through the use or sale the assets. An entity has to test their intangible assets if there is an indication for an impairment los. As an extension paragraph 10b explicitly describes, testing goodwill annually is required, irregardless whether there is in indication for impairment (IFRS 2008, par. 10b).

The new measurement to treat goodwill by FASB in SFAS 142 aims to:

1) Provide a better assessment of goodwill in the statement of financial position,
2) Eliminate the amortization of the arbitrary treatment,
3) Provide a better understanding to users of financial statements regarding the performance of the acquired company, thus it gives a better the ability to predict the company's earnings and cash flows in the future.

Standar Akuntansi Keuangan 22 paragraph 66 concerning goodwill acquired before January 1, 2011 states that:

"Entities applying this statement prospectively for goodwill acquired in the business combination acquisition date prior to 1 January 2011. Therefore, entities should:

a. discontinue the amortization of goodwill from the beginning of the period of the financial year beginning on or after January 1, 2011;
b. eliminate the carrying amount of the related accumulated amortization in respect of goodwill at the beginning of a period of decline in the fiscal year beginning on or after January 1, 2011; and
c. performed an impairment test of goodwill in accordance with PSAK 48 (Revision 2009): Impairment of Assets since the early period of the financial year beginning on or after 1 January 2011."

According to PSAK 48 (Revision 2009), Goodwill is not the subject of amortization but it has to be tested for impairment annually. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. Goodwill should be tested for impairment at a level of reporting as a reporting unit – in this case is called Cash Generating Unit (CGU).

2.1.1.1 Amortization

Based on SFAC 6 paragraph 142, amortization is the accounting process of reducing an amount by periodic payments or write-downs. Specifically, amortization is the process of reducing a liability recorded as a result of a cash receipt by recognizing revenues or reducing an asset recorded as a result of a cash payment by recognizing expenses or costs of production. That is, amortization is an allocation process for accounting for prepayments and deferrals. Under the purchase method, the excess of the acquisition cost over the fair values of the identifiable net assets acquired at the date of acquisition is recognized as goodwill.

According to PSAK 22 (1994) paragraph 39 explains that goodwill has to be amortized as an expense over its useful life. Goodwill amortization periods of 5 years can be extended up to 20 years with appropriate base. The amortization used straight-line method unless there is better method with certain provisions. In 2011, this standard is no longer relevant because the new PSAK 22 (2010) requires goodwill has to be tested for impairment and cannot be amortized.

2.1.1.2 Impairment

In order to fulfil PSAK 22 (2010) which requires goodwill as subject to impairment test, accounting procedure for goodwill arises from acquisition is set on PSAK 48 (2009). According to PSAK 48 (2009) paragraphs 80-81, goodwill acquired at the acquisition date in a business combination should be directly allocated to each of the acquirer's cash-generating units, or groups of cash generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Goodwill allocation to CGU is done as the consideration that goodwill does not generate cash flows independently. It defines CGU as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets. Each unit or group of units to which the goodwill is so allocated should represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and not be larger than an operating segment as defined by PSAK 5 – Operating Segments.

Cash-generating units that have been allocated goodwill must be tested for impairment on an annual basis. The test is performed by comparing the carrying amount of the unit (excluding goodwill) with its recoverable amount. If the recoverable amount exceeds the carrying amount of the unit, then goodwill allocated should not be considered for impairment. Impairment of goodwill should be recognized if the carrying amount of the unit exceeds the recoverable amount.

The recoverable amount is the comparison between the net fair values of the value in use. The net fair value is the fair value less costs to sell, the amount that can be obtained from the sale of an asset or CGU between parties in a fair transaction less costs of disposal (such as whether fair value was determined by reference to an active market). If recoverable amount is value in use, the discount rates used in the current estimate and previous estimate (if any) of value in use. The second way can be seen from the cash flow projections of the testing point to the end of use of the asset in the future; it is taking into the present value for the level of risk, both inflation risk and capital risk.

If the recoverable amount of an individual asset cannot be determined, an impairment loss is recognized for the asset if its carrying amount is greater than the fair value less costs to sell and the results of the allocation procedures; and no impairment loss is recognized for the asset if the related cash-generating unit is not impaired. This applies even if the asset's fair value less costs to sell is less than its carrying amount. The impairment of goodwill should be done with reduce the carrying amount of any goodwill allocated to the CGU.

An entity should disclose the requirements of their impairment test. Not only the impairment described in the financial report, but also the event that led to the impairment, information on the calculation of both method and the class of assets to which the impairment is related in the case of CGUs is information that companies have to disclose.

PSAK 48 (2009) paragraph 12 gives some indication to assess whether there is any indication that an asset may be impaired, as follows:

A. External sources of information:
    1. A significant reduction of the market value which highly above expectation.
    2. The significant negative changes in technology, market, economic or legal environment.
    3. The increase in the market interest rate or rate of return on the investment market.
    4. The carrying amount of the net assets of the entity exceeds its market capitalization.
B. Internal sources of information:
    1. Available evidence of obsolescence or physical damage of an asset.
    2. Significant negative changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

3. Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

2.1.1.3 Differences between Goodwill Amortization and Goodwill Impairment

The changes of goodwill accounting procedures indeed have some differences. Table 2.1 shows the differences between the previous and current standard. PSAK 22 1994 set for goodwill amortization while the curent PSAK 22 2010 sets that goodwill should be tested for impairment.

The differences regarding the periods, the amount, and how it is done will be written on the table below:

Table 2.1

Differences between Goodwill Amortization and Goodwill Impairment

	Amortization	**Impairment**
Standard	PSAK 22 1994 PSAK 19	PSAK 22 2010 PSAK 48
Useful life	5 years can be exceeded up to 20 years with justification	indefinite life
When	Annually; it has to be amortized.	It does not necessary to have impairment loss for each year; but the test of impairment is mandatory each year.
Amount	Same amount for each year	Different amount based on carrying amount compare to its recoverable amount
How	$\frac{amount\ of\ goodwill\ in\ acquisition\ date}{useful\ life}$	Compare carrying amount and recoverable amount recoverable amount: 1. value in use or 2. fair value - cost to sell Impairment = recoverable amount < carrying amount

The findings based on Table 2.1, goodwill is not longer amortized but it has to be tested for impairment. The useful life of goodwill is indefinite means that it cannot be determined. The impairment test is mandatory for annual test and the amount of impairment is based on its recoverable amount compare to carrying amount. Thus the amount of goodwill impairment is not the same each year.

2.2 Earnings

Earnings has been highlighted for years as the final output of to evaluate companies' economic performance. It defined by Financial Accounting Standard Board (FASB) in Statement of Financial Accounting Concept (SFAC) number 5 paragraph 36:

"Earnings is a measure of performance during a period that is concerned primarily with the extent to which asset inflows associated with cash-to-cash cycles substantially completed (or completed) during the period exceed (or are less than) asset outflows associated, directly or indirectly, with the same cycles."

SFAC number 6 explains some components which affects earnings, there are:

1. Revenue
   Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
2. Gain
   Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.
3. Expenses
   Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

4. Losses
   Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

As one of the element of financial statements, it is a must that earnings have to contain information. This information will be useful for the user. Thus, it is very possible for external and internal parties to make some judgments to the current and future economic condition of the company with earnings. According to SFAC 5 paragraph 16 – the usefulness of financial statement, each decision maker judges what accounting information is useful, and that judgment is influenced by factors such as the decisions to be made, the methods of decision making to be used, the information already possessed or obtainable from other sources, and the decision maker's capacity (alone or with professional help) to process the information.

By the internal parties, earnings is used to give bonuses and promotion, also increase ratings and the stock price, even to receive some credits. The external parties use earnings as the achievement of the companies – how much money the companies could make, how effective the company could use its assets. Besides, SFAC number 8, explained that the external parties use earnings to help them evaluate the firms in some aspects that are evaluate earnings power, predict future earnings and also assess the risk of investing in or lending to firms (Hendriksen & Breda, 1992). As in accordance with Ronen & Yaari (2008), it is stated that earnings are so important that it used as the object of management and manipulation. It is trivial because they are trained to regard earnings as the ultimate performance measure.

Teoh et al. (1998) decomposing net income into cash flow from operations and accounting adjustments (referred to as accruals), and they decompose accruals into four categories jointly, as follows:

1. By the time period
    a. Current accruals are adjustments involving short-term assets andliabilities that support the day-to-day operations of the firm. For example, managers can modify current accruals by advancing recognition of revenues withcredit sales (before cash is received), by delaying recognition of expenses aftercash is advanced to suppliers, and by assuming a low provision for bad debts.
    b. Long-term accrualsare adjustments involving long-term net assets. These accruals can be modified by decelerating depreciation, decreasing deferred taxes (the di¤erence between tax expense recognized for financial reporting and actual taxes paid), and realizing unusual gains.
2. By manager control
    a. Discretionary accruals are form by the estimation and managements' policies.
    b. Non-discretionary accrualsare changes that occur beyond the control of management.

Teoh et al. (1998) decompose current accruals and long-term accruals separately because accounting researchers have argued that managers have greater discretion over current accrualsthan over long-term accruals. They conclude that

discretionary current accruals is the component most subject to managerial manipulation.

2.3 Agency Theory and Information Asymmetry

Agency theory implies the existence of information asymmetry between managers as agents and owners (in this case is a shareholder) as principal. Information asymmetry arises when the managers are more aware of the internal information and the company's prospects in the future compared to shareholders and other stakeholders. Associated with the increase in the value of the company – when there is asymmetry of information, managers can provide a signal about the state of the company to investors in order to maximize the value of the company's shares. The signal can be given through disclosure accounting information.

Accounting standards established by the Indonesian Institute of Accountants (IAI) nowadays is following IFRS which allows management to take a choice in applying accounting methods in order to convey information about the company's performance to external parties. They are giving flexibility for management to choose one of a set of accounting policies open up opportunities for opportunistic behavior and efficient contract. Thus, the rational manager will select the appropriate accounting policy regarding their interests. In other words, managers select accounting policies that can maximize his expected utility or the market value of the company. Opportunistic behavior and efficient contract, prompting managers to manage earnings.

2.4 Positive Accounting Theory

Positive accounting theory (PAT) is clearly stated by Watts & Zimmerman (1986). This theory seeks to explain why the accounting policy becomes an issue for the company and the parties concerned with the financial statements, and to predict the accounting policies to be chosen by the company under some certain conditions. This theory is based on the view that the company is a 'nexus of contracts'. That is, the company is an estuary for various contracts that came to him. For example, contracts with employees (including managers), suppliers, and financiers. As a collection of various contracts, rationally contracting company wants to minimize the costs associated with contracts, such as boarding negotiations, monitoring the performance of contracts, the possibility of bankruptcy or failure, and others. Some of those contracts involve variables accounting, and the positive accounting theory argue that the company will utilize its accounting policies in order to minimize the cost of contracting. This condition is reinforced with the provision of flexibility by resident entities to management standards to choose from a set of accounting policies are allowed.

Positive accounting theory using agency theory to explain and predict accounting policy choice by the manager. Positive accounting theory formulated by Watts & Zimmerman (1986) has predicted three hypotheses that encourage companies to undertake earnings management, as follows.

b) The bonus plan hypothesis

Manager of a company that has a bonus program related to accounting numbers tend to choose the accounting procedures that shifts Reported earnings from

period to current and future period (increase reported earnings today), ceteris paribus.

c) The debt covenant hypothesis

Companies that closer breach debt covenants (debt contract agreements) tend to choose the accounting procedures that shifts Reported earnings from future periods to the current period (increase reported earnings today), ceteris paribus.

d) The political cost hypothesis

The greater the political cost that faced by a company, the managers tend to choose the accounting procedures that suspend Reported to the future earnings of the current period (lower earnings reported today), ceteris paribus.

2.5 Earnings Management

With IFRS, the financial statements prepared is on the accrual basis accounting. Accrual accounting has the advantage that the company's earnings information and measurement generally give a better indication of economic performance rather than the information generated from the cash basis accounting (FASB 1978). Accrual accounting also has its weaknesses. Some criticizes that the policies of accrual accounting were not perfect and obscure the financial report which is aiming to provide information about cash flow and the capability of the company to generate cash. The obscurity happen due to accrual accounting policies which give some choices to the reporting entity. Hence, it is very obvious that it will raise vulnerability of information. This vulnerability is called earnings management.

According to Chen (2010), Earnings management is said to be a "reasonable and legal management decision making and reporting, intended to achieve and disclose stable and predictable financial results". Most people are aware of the fact that companies' earnings are their "net income" or "net profit". A company's earning is believed to be the most important item in the financial statements. It is something that the most analysts use when analyzing a company's performance and prospective potential. The most important, the expected value of a company's share price is the present value of all its future earnings, and therefore the value of a company is closely related to the increase or decrease in the earnings. Scott (2006: 344) defines earnings management as choices of the accounting policies applied by the manager which is naturally exist to maximize their utility and/or the market value of the company.

Earnings management is a topic of interest, both for accounting researchers and practitioners. The phenomenon of earnings management has also enliven the business world and the press coverage. Some systematic empirical evidence has shown the existence of this phenomenon of earnings management, including Gu & Lee (1999), De Angelo (1988), Holthausen & Sloan (1995), and others. In particular, Gu & Lee (1999) have shown that earnings management has been expanded and there is in every financial report submitted by the company. They give a proof that earnings management occurs in every quarterly financial statements, and management level are largest profit in the third quarter. This shows that earnings management practices is a common phenomenon, not only in certain events but it has been so deeply rooted in the business.

Scott (2006) divides the way to understand earnings management into two. First, see it as opportunistic behavior of managers to maximize their utility for compensation contract, contract debts, and political costs (opportunistic earnings management). Second, from the perspective of efficient contracting (efficient earnings management), in which earnings management gives managers a flexibility to protect the parties involved in the contract as anticipation of unexpected events. Thus, managers can influence the company's stock market value through profit management, for example by making the income smoothing.

Based on Roychowdury et al. (2015) they stated that earnings management can occur through two channels, which are:

1. **Accruals Management (AM)**

Accruals-based earnings management involves managers' intervention in the financial reporting process via the exercise of their discretion and judgment regarding accounting choices. (Roychowdhury, 2006). Thus, accrual-based earnings management generally used for detecting earnings management regarding to accounting choices and policies. Using accrual based earnings management techniques to meet analysts' forecasts in the United States has been well researched. Accruals are the difference between net income and cash flows. For example, when companies sell items to others on credit during a growth period, the sale creates an accrual of revenue.

When companies engage in earnings management, they can increase or decrease income by creating accruals; these are often referred to as non-discretionary accruals. However, it is the discretionary accruals, accruals created

to manipulate changes in reported earnings that are of concern. These types of accruals include using increasing or decreasing estimates of bad debt reserves, warranty costs, and inventory write-downs. (Moore et al., 2009)

Such research requires a model that estimates the discretionary components of reported income. Existing models range from simple models in which discretionary accruals are measured as total accruals, to more sophisticated models that attempt to separate total accruals into discretionary and nondiscretionary components. Many of the non-discretionary accruals estimate the model from the company's past accruals level prior to the period when there is no systematic earnings management (Jones, 1991). The other alternative is using cross sectional approach where the level of the company's normal accrual in an accrual period compared with the comparison companies in the same period (Defond & Jiambavlo, 1992). By the research; either time series or cross-sectional face the issue with the accrual occurs will vary according to changes in business conditions.

From the past research in their attempt to study accruals use two models: Healy (1985) and DeAngelo (1986) use total accruals as a proxy for earnings management while Jones (1991), Dechow, et al. (1995), Yoon & Miller (2006) use discretionary accruals as a measure of earnings management. Later, they found that modified Jones model is the most powerful model to detect earnings management.

2. **Real Activity Management (RAM)**.

Earnings management through real activity can be detected through operating cash flows, discretionary costs, and production costs. Research on the earnings management through real activities concentrate on the investment activities such as

research and development spending reductions. Roychowdury (2006) provide evidence that the manager manipulation through real activity by giving rebates to increase sales, reduce cost of goods sold through an increase in inventories, and reduced discretionary expenses to increase reported earnings. Real activities manipulation can assume many forms, including under-investment in research and development (R&D), advertising, and employee training, all for the purpose of meeting short-term goals. Marketing strategies, tactics, and budgets are often at the center of implementing real activity-based earnings management as well.

Roychowdury (2006) says that the earnings management through real activities manipulation is the shift from the profit management practices into normal operation abnormal operating practices, motivated by the desire managers to deceive some stakeholders in order to believe the financial statements are prepared on the basis of normal operation. Displacement of normal operating practice is not normal to not contribute to the value of the company despite reporting managers achieve goals. Managers involved profit management concerned with personal gain to achieve the objectives of reporting because they act as an agent. For example, earnings management to avoid losses, and avoid debt covenant violations, to avoid government intervention, as well as to increase the bonus.

In Indonesia, the research on the manipulation of real activity has been carried out by Andayani (2008). The result is a manufacturing company doing overproduction, discounts, credits and allowances as an indication of earnings management, which led to high production costs.

2.6 The Effect of Goodwill Impairment on Earnings Management and the Role of Control Variables

Based on researches, there are many evidences that goodwill impairment used as a tool to manage earnings. The new standard is intended to shift the reported values of goodwill from the historical costs towards the comparison between carrying amount and recoverable amount of goodwill. The recoverable amount of goodwill would involve management discretion which allow managerial doing assumptions and estimation. From determining recoverable amount, managers have the opportunity to manipulate the value of the "fair value less cost to sell" and the "value in use" as it requires the management's estimation. Thus, subjectivity is highly provided in the steps to determining the amount of goodwill impairment. Thereby, the managerial discretion is a great opportunity for the management to perform the earnings management. The new goodwill guideline then might be used as an earnings management tool. This is supported by researches who found that managers are exploiting their discretion in recognizing goodwill impairments to manage earnings.

However, goodwill impairment is not the only factor affecting earnings management. Based on Jogiyanto (2013) there is extraneous variable which can affect causal relationship. This research will use control variable as extraneous variable to maintaining, completing and controlling the causal relationship for getting a better and complete empirical model. This variable is not the main variables that will be researched and tested but it rather have the effect to influence variables. There are some control variables that may influence managers'

accounting choices. The control variable is defined as the variable that is used to maintaining, completing, and controlling the relationship between dependent. The control variables are taken from the previous studies suggestion with some modification.

The control variable from the previous studies are audit quality (Big_4), board size (Bsize), leverage (Lev), operating cash flows (CFs), performance (Performance) and political costs (Size) are associated with earnings management. (Alves, 2013) This research will eliminate audit quality (Big_4) and performance (Performance) as the evaluation of the previous result suggest no evidence those control variables affect the levels of earnings management.

Therefore, control variables will be measured as follows:

1. Board size ($Bsize_{it}$)

According to Jensen (1993) board size is related to board effectiveness. The higher the number of members on the board the greater the monitoring activity of management. If large boards enhance monitoring, they would be associated with less use of earnings management. Jensen (1993) also noted that the loss because of the higher number of commissioners are concerned with two things: the increasing number of personnel commissioners and the decline in their ability to control the management will increase the problems in terms of communication and coordination. Thus, it raises agency problems from the separation between the management and control. Alves (2013) find that larger boards are associated with lower levels of discretionary accruals.

2. Leverage (Lev_{it})

Companies with higher debt levels increase the risk of violating debt covenants. The risk of violating debt covenant will motivate the managers to manipulate earnings to comply with it. Based on DeFond & Jiambalvo in Becker et. al (1998) debt covenant violation is associated with discretionary accrual choice. To avoid debt covenant violation, managers will tend to make income-increasing discretionary accruals. In the other hand, troubled companies lead to financial distress which have large negative accruals related to earnings reduction. However, monitoring by external lenders reduces the opportunities to manipulate earnings (Park and Shin, 2004).

3. Operating cash flows (CFs_{it})

Dechow et al. (1995) firm with deteriorating cash flows may try to manage accruals upward to avoid reporting deteriorating earnings. So, reporting a good one might be an incentive for managers to manage earnings and signal future performance of the company (Demirkan & Platt, 2009). Alves (2013) find that operating cash flows are negatively associated with discretionary accruals, suggesting that firms with strong operating cash flows are less likely to use discretionary accruals to engage in earnings management.

4. Political cost ($Size_{it}$)

The size of the company can determine how great earnings management practices done by managers. Positive accounting theory suggests that managers of large firms are more likely to exploit latitude in accounting to reduce political costs (Watts & Zimmerman, 1986). Therefore, large firms are more likely to choose

income decreasing earnings management in order to reduce the probability of adverse impact from political exposure (the political cost (size) hypothesis). Some researchers find that large firms face more pressures than small firms to meet or beat the analysts' expectations (Barton & Simko, 2002). But, large companies tend to act cautiously in managing the company and tend efficiently managing earnings. Zhou & Elder in Christiani & Nugrahanti (2014) states that large companies tend to reduce earnings management measures to avoid the strict supervision of financial analysts and investors. Chen et al. in Alves (2013) find that larger firms are associated with higher absolute discretionary accruals.

2.7 Previous Studies

Research regarding goodwill impairment and earnings management has been done by some researcher in the past. The first research was done by Jordan & Clark (2005). They used Return on Assets (ROA) and Return on Sales (ROS) as the measurement to determine earnings management with the comparison of before and after the standard is revised. The research was resulting in firms engaged in big bath earnings management from its goodwill impairment losses recognized in year 2002. Then, they made a research again to firms in year 2003 and 2004 which companies are suffered from depressed earnings. The research found the signs that goodwill write-downs still used as big bath earnings management, which the entities not recording impairment losses. Management likely anticipated that lowering earnings even further for these impairment losses would harm the market value of their firms' shares. The other research done by Van de Poel et al. (2009) study whether

the IFRS goodwill impairment test is used as tool to manage earnings. Their findings support that companies typically take their impairments when earnings are 'unexpectedly' high (smoothing) or when they are 'unexpectedly' low (big bath accounting).

The latest research is done by Alves (2013) with different measurement to detect earnings management. The researcher uses discretionary accrual as the measurement of earnings management with the consideration that goodwill impairment is included as the management discretions. Besides, the modified Jones model which is used to determine discretionary accruals is more powerful to detect earnings management. The researcher also use audit quality, board size, leverage, operating cash flows, performance and political costs as the control variables. The result shows that goodwill impairment loss is used to manage earnings. It found that goodwill impairment is significantly positively related to earnings management, suggesting that IAS 36 provides managers too much discretion for goodwill write-off. This result explain the idea that IAS 36 involves managers' estimation of parameters, such as cash flow and discount rate. Those are the subjective component in the determination of goodwill impairment loss which open up the opportunity for manager to do earnings management. Moreover, the results also reveal that there is less earnings management when the board size is large and when cash flows are high and that there is more earnings management when leverage and political costs are high.

In Indonesia, research regarding goodwill impairment and earnings management developed by Dewi K. (2014) using the samples of Indonesian

company to take the empirical evidence of Van de Poel et al. (2009) study in Indonesia as the replication of Walangitan (2011). In the study, the researcher follow the previous to use Return on Assets (ROA) and Return on Sales (ROS) to determine earnings management with the comparison of before and after the standard is revised. The researcher found out that there is no indication of big bath earnings management in Indonesia yet the management tend to do earnings smoothing with the recognition of goodwill impairment loss.

2.8 Hypothesis Development

The current standard for goodwill requires that the amount of goodwill needs to be tested annually to determine whether any changes in value have occurred. PSAK 48 (Revision 2009) as the convergence of IAS 36 contains the specific requirement that goodwill is subject to a mandatory annual test of impairment and should be impaired to fair value, if necessary. The purpose of the new standard IAS 36 is to prohibit the method of goodwill amortization that leads to arbitrary accounting. By using the impairment method, it is possible for a company's management to process several assumptions in the impairment test. Evaluation of fair value and assessment of impairment of goodwill requires management judgment which in fact, can bring a higher of subjectivity in the valuation of goodwill. So, even though an annual impairment test is mandatory, the actual recognition of a goodwill impairment loss is still subject to management's discretion and highly subjective.

Goodwill impairment losses will affect the accruals, because they lower the reported earnings while they have no influence on the cash flows from operations.

Therefore, accounting for goodwill impairment loss provides chances for earnings management. Given that recoverable values are not readily available for many cash generating unit (CGU) to which goodwill balances were assigned, managers enjoy a certain amount of discretion when applying the impairment test.

It is hard and challenging to detect or measure earnings management. It is not possible to observe earnings management directly. Therefore, previous researchers have investigated two venues for earnings management, the choice of accounting methods and the management of accruals. Past research in their attempt to study accruals use two models: Healy (1985) and DeAngelo (1986) use total accruals as a proxy for earnings management while Jones (1991), Dechow et al. (1995), Yoon & Miller (2006) use discretionary accruals as a measure of earnings management. The possible explanation to exclude non-discretionary accruals is that since non-discretionary accruals are used to reflect business condition; subject to firms condition and sales growth and thus it cannot be controlled by managers, it is excluded from the studies.

The most popular discretionary model is the standard Jones (1991) model. This model is able to decompose accruals into discretionary and non-discretionary accruals. When changes in sales are adjusted for the change in receivables, standard Jones model becomes a modified Jones model, which is proposed by Dechow et al. (1995). The modified model is designed to reduce the measurement error of discretionary accruals when discretion is applied over sale. The study by Dechow et al. (1995) finds that a modified Jones model provides the most powerful test of earnings management compared to Healy DeAngelo and standard Jones and

industry model. Moreover, previous studies (Alves, 2013) suggest that determining earnings management using discretionary accruals gave better result. The suggestion comes up with the discretionary accruals model developed by Jones (1991) which is very famous and used to many research. The modified Jones model developed by Dechow et al. (1995) represent the current discretionary accrual by adding one more item which is receivables. (Patro & Pattanayak, 2014)

Alves (2013) suggested to include control variables as goodwill impairment is not the only factor to managed earnings. The control variables which are significant will be used in this research, there are board size, leverage, operating cash flow and political cost. Therefore, it is predicted that goodwill impairment will affect earnings management using discretionary accruals as the measurement. Therefore the hypothesis developed:

Ha: Goodwill impairment positively affects earnings management measured using discretionary accruals with board size, leverage, operating cash flows and political cost as the control variables.