# CHAPTER I

# INTRODUCTION

## 1.1. Background

The accounting information about the company's performance is really crucial for the investors in the capital market to make a decision. One of the sources is financial report. Financial report is the form of management's responsibility in managing the economic resources trusted to them.

According to SFAC no. 8 (2010), the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, holding equity and debt, and providing loans and other forms of credit. The information provided in financial reporting is important to help the users of financial report assess the prospects for future net cash inflows to an entity, identify the reporting entity's financial strengths and weaknesses, and understand the return that the entity has produced on its economic resources. In order to do that, the users need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

Profit is one of the benchmark used by the users of financial report in appraising the company's performance. SFAC no. 1 (1978) stated that the primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components. Financial reports are made by the management of the company.

Managers are employed to run the company on behalf of the owner. They have responsibility to give information about the underlying condition of the company to the owner. Both managers and shareholders have different information. Shareholders as principals give the controls and management of the company to the managers. As the runner of the company, the managers will have more knowledge about internal information and the prospect of the company rather than the shareholders.

Sometimes the information received by the users is not the real underlying condition of the company. It makes the users such as investors and creditors do mistake in making the decisions. The owner's objective is not always in accordance with the objective of the manager. This situation can lead to a problem that is commonly called as conflict of interests. The managers can act only based on their interest that will lead them to take some private gain and ignore the interest of the shareholders.

Managers are competing in the labor market because they are the agent. Managers with good reputation will have opportunities to get better job and vice versa. Their reputation is related with their performance in running the company. If the top management or the CEO position of the company can do their job well, so the company can achieve its main goal. It is important for the CEOs to get achievement every year and fulfill the objective of both the owner of the company (principal) and the CEOs (agent). The owner of the company can fire the managers if the company under their direction has bad performance.

CEO turnover is a common phenomenon. According to Anderson and Lilja (2013), even if companies put a lot of effort in the choice of CEO, the CEOs turnover increased every decade since 1970 with a more significant change after 1992. Kaplan and Minton (2008) stated that structural changes, emergence, cost saving programs, reorganizations, and increasing demand for short term tenures are some explanations for increasing tenure.

There are at least two factors that can drive the CEO turnover event. First, the tenure of the old CEO is up and the company needs to change the position with the new CEO. This is a normal condition from the CEO turnover event. This condition is often called as CEO turnover routine. CEO turnover routine is a planned process that is known by both the old CEO and the new CEO.

Second, the old CEO cannot run the company well and the company cannot achieve its main goal. CEO turnover is a good strategy for a company that has a bad condition. This CEO turnover is expected to give better prospect. This condition is often called as CEO turnover non-routine. CEO turnover non-routine is an unplanned process and the company has a limited time to choose the new CEO who will replace the position of the old CEO (Wells, 2002). But the company is said to be unstable if the company too often experienced CEO turnover every year.

Turnover in the CEO position is a frequent phenomenon. Nowadays, new CEOs increasingly come from outside the company rather than through internal promotions. The choice of an external hire is not an exogenous shock, but rather is endogenous to CEO and firm characteristics (Kuang et al., 2014), which also could drive firm's earnings management.

Like other countries, in Indonesia, turnover in CEO position is often happen. The turnover of the CEOs can give impact to earnings management because it involves decisions by both the departing and incoming CEOs (Choi et al., 2012). 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 company's economic performance or to influence contractual outcomes that depend on reported accounting numbers (Healy and Wahlen, 1999). Earnings management can be done either through accrual manipulation or real activities manipulation. Real activities manipulation is earnings management done by the managers which deviate from normal business practices aimed of achieving certain earnings (Roychodhury, 2006). Usually manager is more likely to use real activities manipulation rather than accrual manipulation. There are two reasons behind this condition. First, accrual manipulation more often becomes the center of observation or inspection by the auditors and the regulators. Second, focus attention only on accrual manipulation is a risky action because the company may have limited flexibility to manage accrual (Graham et al., 2005).

In Indonesia, many studies about earnings management have been done. Researches on earnings management that have been done in Indonesia mostly investigated the relationship between earnings management and the investors reaction in the stock market. Studies that examine whether new CEOs in Indonesian companies practice earnings management have not been done so much, those studies are still in a few amounts. Most of prior studies about earnings management in Indonesia are concern about the practice of earnings management from market performance perspective.

The example of CEO turnover event in Indonesia is the CEO turnover in PT Indosat Tbk. The shareholders of PT Indosat Tbk agreed to change the composition of directors and commissioners in the general meeting of extraordinary shareholders. For the position of President and CEO which formerly held by Harry Sasangko Tirtotjondro replaced by Alexander Rusli. This change became effective on November 1, 2012.

Rusli had previously been an Independent Commissioner at Indosat since January 2010. Currently he is a member of the Remuneration Committee and the Audit Committee of Indosat. In the board of commissioner positions, Rudiantara will enter as Independent Commissioner of Indosat from 1 November 2012. Rudiantara is not a new people in the telecommunications industry because he has ever been in the top position in Telkomsel and XL.

This research is different from prior researches about earnings management because this research will examine the behavior of earnings management at the turnover of the CEOs in Indonesia. This research will examine the turnover of the CEOs based on the origin of the CEO. CEO origin is the origin of CEO whether they are promoted from within the company or externally recruited. CEO origin is an important factor for explaining financial reporting strategies (Kuang et al., 2014). Most of the researches about CEO turnover only differentiate between routine and non-routine departures. The researches did not separate whether the incoming is through internal promotion or external recruitment.

There are some motivations for the CEOs in doing earnings management. Those motivations are stock market motivation, signaling or concealing private information, political costs motivation, CEO turnover, bonus plan motivation, debt covenant motivation, and regulatory motivation (Rahman et al., 2013). This research will examine the earnings management done by the CEOs with CEO turnover as the motivation.

There are four patterns of earnings management: taking a bath, income minimization, income minimization, and income smoothing (Scott, 2006). This research will examine the earnings management done by the CEOs with income maximization as the pattern of earnings management through real activity manipulation.

Based on Kuang et al. (2014) research, they find that compared with CEOs promoted from within the company, CEOs recruited from outside have a stronger incentive to demonstrate their abilities in the initial years after their appointment. They also have lower survival expectations. They predict and find that outside CEOs engage in greater income-increasing manipulation after their appointment.

This research is expected to give the same results as in Kuang et al. (2014) research. This study will give empirical evidence that will support the previous research.

## 1.2. Research Problem

This research wants to find whether there is an impact on earnings management from the origin of the CEO. CEO origin is the origin of CEO whether they are promoted from within the company or externally recruited.

As a result, there is a research problem that arises from this research:

a. Does CEO origin give impact on earnings management through real activities manipulation?

## 1.3. Research Objective

This research will give empirical evidence that:

a. CEO origin gives impact on earnings management through real activities manipulation.

## 1.4. Research Contribution

1. For Practices

   This research can be used as an additional knowledge about the earnings management behavior of CEOs origin in the real activities manipulation.

2. For Researchers

   The result of this research will give support for the future research about the impact of CEO origin on earnings management through real activities manipulation.

3. For Investor

   This research can be used as knowledge about CEO turnover event. The information within this knowledge can be used by the investors as a consideration in making the decisions, so they can optimize the benefits and minimize the risks in their investment.

## 1.5. The Systematic of Writing

Chapter I Introduction

Chapter I consists of background, research problem, research objective, and research contribution.

Chapter II Literature Review and Hypothesis Development

Chapter II consists of the theories as the basis of this study and hypothesis of this study.

Chapter III Research Methodology

Chapter III explains about sample, variables and the measurement, hypothesis testing, and data analysis methods.

Chapter IV Results and Analysis

Chapter IV consists of descriptive statistics, the results of data analysis, the results of hypothesis testing, and discussion.

Chapter V Conclusion

Chapter V consists of conclusion of this research, research limitations, and suggestions for future research.