CHAPTER II

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1. Agency Theory

In a situation where the management is also the owner of the company, costs related to opportunistic behavior by the management will in addition be incurred by the management. However, in a situation in which a separation exists between management and the ownership of a company, the opportunistic behavior of management will have an impact on the wealth of the party that owns the company (Assem, 2011). The main trigger for the CEO turnover is the failing of achievement of common goals between the manager and owner of the company.

Agency theory is a theory about the relationship between shareholder of a company as the principal and the manager of the company as the agent. Jansen and Meckling (1976) defined the agency relationship as a contract under which one or more (principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.

Agency conflict arises as a consequence of the differences between the objectives of both principal and manager of the company. The principal wants the agent to work hard to maximize the shareholder’s wealth. In the other hand, the agent tends to maximize his or her own interests. The owner of the company delegates the authority and responsibility to the manager to run and manage the company. The owner does not act actively in managing the
company. This authority gives incentive to the manager to act based on their interests.

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. This condition will lead to the information asymmetry. There are two types of information asymmetry: adverse selection and moral hazard. Adverse selection is the condition where a party who is doing business transaction has more information than other parties. It happens because the manager of the company has better understanding about the current condition and the prospect of the company rather than the investors. Moral hazard is the condition where one party or more who are doing business transaction can observe their action, but other parties cannot do that thing. It happens because there is a separation between ownership and management as the characteristics of most companies. These two information asymmetry can drive to some serious implications for the performance and the sustainability of the company because the manager can alter and manipulate the actual information about investment opportunity and company’s prospect.

According to Jensen and Meckling (1976), agency costs are the sum of monitoring expenditures by the principal, bonding expenditure by the agent, and residual loss. Monitoring expenditures are the monitoring costs to be incurred by the principal to limit the aberrant activities of the agent. Bonding expenditures are the costs to guarantee that the agent will not take certain actions which would harm the principal or to ensure that the principal will be
compensated if he or she does take such actions. Residual loss is the dollar equivalent of the reduction in welfare experienced by the principal as a result of this divergence.

According to Eisenhardt (1989), agency theory is based on the three assumptions. Those assumptions are human nature assumptions, organizational assumptions, and information assumptions. Human nature assumptions emphasize that human has selfishness (self-interest), has limited rationality (bounded rationality), and do not like risk (risk aversion). Organizational assumptions are the existence of a conflict between organization’s members, efficiency as the criteria for effectiveness, and the existence of information asymmetry between principal and agent. Information assumptions emphasize that information is commodities that can be traded.

2.2. Positive Accounting Theory

Economic Consequences and Positive Accounting Theory explain detail about Positive Accounting Theory. The objective of the theory is to predict managerial accounting choice in different circumstances and across different firms. PAT argues that firms’ accounting policies will be chosen as part of the broader problem of attaining efficient corporate governance.

PAT does not suggest that firms should completely specify the accounting policies they will use. This would be too costly. It is desirable to give managers some flexibility to choose from a set of available accounting policies, so that they can adapt to new or unforeseen circumstances. The set of available accounting policies usually can be taken as those allowed under GAAP.
However, giving management flexibility to choose from a set of accounting policies opens up the possibility of opportune behavior. That is, given the available set, managers may choose accounting policies from the set for their own purposes.

PAT assumes that managers are rational like investors and will choose accounting policies in their own best interests if able to do so. That is, managers maximize their own expected utility. The manager will only maximize profits if he or she perceives this to be in his or her own best interests. Managers choose accounting policies in their own best interests, which may not necessarily also be in the firms’ best interests.

There are three hypotheses of positive accounting theory (Watts and Zimmerman, 1986). These three hypotheses are bonus plan hypothesis, debt covenant hypothesis, and political cost hypothesis. These hypotheses are the managers’ concerns about accounting policies and standards that are driven by opportunism.

1) The Bonus Plan Hypothesis
   Firm managers, like everyone else, would like high remuneration. If their remuneration depends on a bonus related to reported net income, then they may be able to increase their current bonus by reporting as high a net income as possible. One way to do this is to choose accounting policies that increase current reported earnings. If the manager is a risk averse, he or she will prefer accounting policies that smooth reported earnings, since a less variable bonus stream has higher expected utility than a volatile one.
2) The Debt Covenant Hypothesis

The debt covenant hypothesis is related to the credit facilities obtained by the company on the capital market (Assem, 2011). Increasing reported net income will reduce the probability of technical default. Most debt agreements contain covenants that the borrower must meet during the term of the agreement. If such covenants are violated, the debt agreement may impose penalties, such as constraints on dividends or additional borrowings. The prospect of covenant violation constrains management’s actions in running the firm. To prevent, or at least postpone, such violation, management may adopt accounting policies to raise current earnings. As the firm approaches default, or if it actually is in default, it is more likely to do this.

3) The Political Cost Hypothesis

The political cost hypothesis is related to the attention that the company receives from outside parties such as environmental groups and competitors. The size of the company and the level of the earnings are considered to be proxies for political or public attention (Assem, 2011). Such attention can quickly translate into political heat on the firm and politicians may respond with new taxes or other regulations. One way to reduce the attention is by adopting income decreasing accounting policies in an attempt to convince the government that profits are suffering.

Thus, managers concerns about accounting policies and standards may be driven by opportunism or by efficient contracting. From an opportunistic
perspective, the ability of management to select accounting policies for its own advantage is affected. It assumes that management will mostly act in their own interest to increase their own wealth. From an efficiency perspective, the set of available policies affects the firm’s flexibility. It assumes that good incentives schemes, good corporate governance, and good control system will motivate the management to act in the best interest of the company.

2.3. **Chief Executive Officer (CEO)**

Chief Executive Officer (CEO) is someone who holds the highest rank in the list of full time executives reported in the company’s quarterly and annual report (Choi et al., 2012). According to Adiasih and Kusuma (2011), in general, there are some duties of CEOs. These duties are:

1. Led the company by publishing company policies
2. Selecting, establishing, and overseeing the duties of the employees and the head part (managers)
3. Approve the company’s annual budget
4. Submit a report about the company’s performance to shareholders

There are at least two situations which can drive the event of CEOs turnover. 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 (Wells, 2002).
For instance, old CEOs quit from their position and served as the board of commissioner, while the new CEOs recruited from within the company. The consequence of this relation is that the new CEOs maybe reluctant to undertake earnings management, so that he or she can provide a good attribute to their predecessors (Wells, 2002). Inside successors are more likely to be appointed when firms intend to continue with the current strategy, maintain performance, boost within-firm loyalty and morale, capitalize on insiders’ firm specific knowledge and skills, and minimize the risk of a poor fit between new CEOs and the firm due to inadequate information about external candidates (Farrell and Whidbee, 2003 in Kuang et al., 2014).

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).

For instance, CEO was fired from his or her position because of poor performance or because the CEO was caught doing earnings management. When the old CEO is fired, the company will recruit a new CEO (they are likely to come from outside the company) in a relatively short time (Wells, 2002). Outside CEOs are often hired when firms want new leadership, a new direction or a new strategy.
CEO origin is the origin of CEO whether they are promoted from within the company or externally recruited. So, based on their origin, CEOs can be differentiated as inside CEOs and outside CEOs. Outside CEOs exhibit a stronger desire to demonstrate superior performance immediately after taking helm. Their desire to demonstrate capable performance provides outside CEOs with a stronger incentive to engage in greater income-increasing manipulation after their appointment (Kuang et al., 2014).

There are some reasons for this condition. First, new CEOs’ abilities are not known to the market, they worry about dismissal due to unsatisfactory performance, and therefore report earnings more aggressively than long-tenured CEOs who already have established their ability and are more concerned with preserving their reputations (Hermalin and Weisbach, 1998). Second, CEO hired from outside face more intense pressure to show quick results relative to their inside counterparts. Third, outside CEOs often regard their external recruitment as an opportunity for improving their career paths, so they pay more attention to how the labor market evaluates their capabilities than do their inside peers (Kuang et al., 2014). Fourth, outside CEO successors lack firm-specific human capital or a track record specific to the firm, so the market must rely on the firm’s performance after the CEO appointment to evaluate the CEO’s quality (Hermalin and Weisbach, 1998).

Prior researches also indicate that outside CEOs tend to remain in office for shorter times than their inside peers (Shen and Cannella, 2002). There are two reasons for this condition. First, hostility from existing senior managers
and the outside CEO’s own lack of firm-specific knowledge may work against an outside CEO’s efforts to initiate strategic changes to achieve initial objectives (Allgood and Farrell, 2003). Second, a corporate board also could have overestimated the outsider’s abilities during the CEO selection process because it lacked sufficient information about the abilities of the external candidates.

A weak expectation to stay in office causes outside CEOs to be less concerned about the effects of earnings manipulation in later period. Outside CEOs are less likely to bear the long-term consequences of their actions because they will have already left the firm for their next appointment (Kuang et al., 2014). If an outside CEOs can survive the early years of her or his tenure, then this leader will have established a reputation and proven her or his abilities to the board and the labor market (Shen and Cannella, 2002; Allgood and Farrell, 2003). Then, expectation about these CEOs staying with the firm become comparable to those for inside CEOs. They stand an equal chance of facing the long-term consequences of their actions (Kuang et al., 2014).

2.4. Earnings Management

Earnings are the profit of a company and the vital item in financial statement because it represents to what extent the company engaged in value added activities. Earnings are the powerful indicators of the firms’ business activities. Since a company’s stock is measured by the present value of its future earnings, investors and analysts look to earnings to determine the attractiveness of a particular stock. Companies with poor earnings prospects
will typically have lower share prices than those with good prospects. So, earnings management plays a key role to determine the share price of a company as well as direct resource allocation in capital market (Rahman et al., 2013).

Shareholders are interested whether earnings management is being practiced or not by the business organization because company’s value is directly related with future earnings. Management also has a key interest in how earnings are reported and every executive needs to understand the effect of their accounting choices or learn to manage earnings, so that they can make the best possible decisions for the company (Rahman et al., 2013). Since auditing is imperfect, a possibility for managers arises to use a preferable reporting method which does not truthfully reflect the company’s actual financial status, i.e. earnings management (Healy and Wahlen, 1999).

CEO has access to the information in the financial reports. This access gives ability to CEO to determine the form and content of information in the financial report. The intervene of management in external financial reports which aims to give priority to private interests will benefit the management. However, these actions can harm others who use the information in the financial reports because the information contained does not reflect actual condition.

For outsiders, its difficult to detect the use of earnings management from the financial statement and financial report because of its complexity. The use of earnings management by the CEO of a company remains undetected for
outsiders because its difficult for them to find the abnormalities. 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).

Legal earnings management means financial reports are adjusted in line with financial reporting standards. Earnings management becomes fraudulent financial reporting when it falls outside the bounds of acceptable accounting practice. Therefore, companies will only engage in earnings management when the benefits of this behavior are higher than the risks and costs involved. Management’s use of judgment in financial reporting has both costs and benefits. The costs are the potential misallocation of resources that arise from earnings management. The benefits are potential improvements in management’s credible communication of private information to external stakeholders (Healy and Wahlen, 1998).

2.4.1. The Patterns of Earnings Management

According to Scott (2006), there are four patterns of earnings management. These patterns are taking a bath, income minimization, income maximization, and income smoothing.

2.4.1.1. Taking a Bath

This pattern of earnings management is also called big bath. Sometimes it is additionally referred to as cookie jar accounting because the
management of the company reduces the current year earnings and puts the earnings in a jar for the use in the future years when the earnings are considered to be more valuable. Management of the company usually do the taking a bath during the period of losses or reorganization in a company (Assem, 2011).

The new CEOs will be benefited by this condition because it will give a good impact on their rewards as the big bath accounting boosts future income of the company. In the other hand, the old CEOs are often blamed for the poor performance in the year the big bath accounting takes places (Ronen and Yaari, 2008 in Assem, 2011).

However, this income-decreasing strategy is less useful for outside CEOs than it is for insiders, for two reasons: (1) CEOs hired from outside face more intense pressure to show quick results relative to their inside counterparts, and (2) outside CEOs are less likely to benefit from reserved “cookie jar” earnings later in their tenure because they are less likely to be around when these accruals become available (Kuang et al., 2014).

2.4.1.2. Income Minimization

This pattern of earnings management is quite similar to big bath accounting. It includes writing off some assets and expensing for current and future expenditures. In contrast to big bath accounting, income minimization is not practiced to increase the chance to report future profits, but only to lower the current income of the firm (Assem, 2011).
This pattern is done by making profits on the financial statement of the current period lower than the actual profits. This pattern is done when the level of corporate profitability is high enough. Management typically does this pattern to avoid the political cost, for instance, income tax. Firms are subject to tax. The higher earnings of a company, the higher income tax it has to pay to the government.

2.4.1.3. **Income Maximization**

This pattern of earnings management is the opposite of income minimization. It is expected that management of companies with a small negative result or a result that is close to zero will perform income maximization (Dechow et al., 2003 in Assem, 2011). In performing income maximization, management can boost the earnings management or engage in real transactions. This pattern is done by making profits on the financial statement of the current period higher than the actual profits.

2.4.1.4. **Income Smoothing**

In periods of high earnings, management to a certain level will decrease the earnings and in periods of low earnings, increase earnings of the company (Bao and Bao, 2004 in Assem, 2011). This pattern is done to obtain a stable profit levels and reduce fluctuations in earnings, so that the company is stable. Stable income level makes the owners and the creditors have more confidence in the managers.

2.4.2. **The Motivations of Earnings Management**
According to Rahman et al. (2013), there are some motivations behind the earnings management practice. These motivations are stock market motivation, signaling or concealing private information, political cost, CEO turnover, bonus plan motivation, debt covenant motivation, and regulatory motivation.

2.4.2.1. Stock Market Motivation

Investors often rely on the views and forecasts of stock market by the analysts. Meeting the analysts’ expectations is important because firms that meet or beat expectations can have higher returns. Managers of companies often do earnings management to be able to meet the analysts’ expectations. Missing an earnings benchmark has negative implications for both stock returns and CEO compensation. If pre-managed earnings are below the forecast, managers use income-increasing earnings management. If pre-managed earnings are higher than the forecast, managers can choose between income-decreasing earnings management or not managing the earnings.

2.4.2.2. Signaling or Concealing Private Information

Firms that are failing in achieving the earnings target will engage in earnings management. They alter their financial report to conceal their financial struggle.

2.4.2.3. Political Cost

Firms engage in earnings management to influence shareholders’ opinions and decisions. They also alter their financial reports to escape
from governmental interference. The government interference can be done through governmental regulations and tax laws. When accounting numbers are the basic for tax calculation, the companies will do earnings management in order to avoid large tax.

2.4.2.4. CEO Turnover

A new CEO can be tending to downwards earnings management in the year of change and upwards earnings management in the following years. Retiring CEOs use upwards earnings management to keep a seat on the board.

2.4.2.5. Bonus Plan Motivation

The bonus plan hypothesis contends that CEOs are motivated to use earnings management to improve their compensation since management bonuses are often tied to the earnings of the company. It is expected that earnings management is used to increase income.

2.4.2.6. Debt Covenant Motivation

Debt covenant hypothesis is based on the fact that creditors often impose restrictions on the payment of dividends, share buybacks, and the issuing of additional debt in terms of reported accounting figures and ratios in order to ensure the repayment of the firm’s borrowings. Firms that have a lot of debts have an incentive to manage earnings, so that they do not breach their debt covenants.

2.4.2.7. Regulatory Motivation
Some industries, in particular the banking, insurance, and utility industries are monitored for compliance with regulations linked to accounting figures and ratios. Banks and insurance firms especially are often subject to requirements that they have enough capital or assets to meet their liabilities. Such regulations may give managers incentives to use earnings management.

2.5. **Real Activities Manipulation**

Roychowdhury (2006) has explained detail about earnings management through real activities manipulation. Real activities manipulation is defined as departures from normal operational practices, motivated by managers’ desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations. Real activities manipulation is practiced to meet reporting goals and annual analyst forecast. It can reduce firm value because actions taken in the current period to increase earnings can have a negative effect on cash flows in future period.

Although real activities manipulation potentially imposes greater long-term costs on the company, financial executives indicate a greater willingness to manipulate earnings through real activities rather than accruals (Graham et al., 2005). There are at least two possible reasons for this. First, accrual manipulation is more likely to draw auditor or regulatory scrutiny than real decisions about pricing and production. Second, relying on accrual manipulation alone entails a risk.
This manipulation affects cash flows. There are three variables that should capture the effect of real operations better than accruals. These variables are cash flow from operation (CFO), production costs, and discretionary expenses.

CFO represents cash flow from operations as reported in the statement of cash flows. Discretionary expenses are defined as the sum of advertising expenses, R&D expenses, and selling, general, and administrative (SG&A) expenses. Production costs are defined as the sum of COGS and change in inventory during the period.

The measurement for real earnings management are abnormal cash flows, abnormal production costs, and abnormal discretionary expenses. The abnormal cash flows, abnormal production costs, and abnormal discretionary expenses are computed as the difference between the actual values and the normal values.

Roychowdhury (2006) focus on the following three manipulation methods and their effects on the abnormal levels of the three variables:
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.
2. Reduction of discretionary expenditures.
3. Overproduction or increasing production to report lower COGS.

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\frac{CFO_t}{Assets_{t-1}} = \alpha_0 + \alpha_1 \frac{Sales_t}{Assets_{t-1}} + \alpha_2 \frac{\Delta Sales_t}{Assets_{t-1}} + \epsilon_t \tag{1}
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There are several researches that have been done and that are related with this study. The previous researches are:

a) Research conducted by Andersson and Lilja (2013). The title is Earnings Management in Times of CEO Turnover. This study investigates whether corporations use earnings management in relation with CEO turnover and how the CEO origin, CEO age, company size, and company industry belonging affect earnings management on the Swedish market. The variables in this study are earnings management, CEO turnover, CEO origin (external or internal), CEO age, company size, and company industry. The results showed that there is upward earnings management in the year of CEO change, but not the following year. Earnings management occurs in times of CEO turnover, there is no difference of earnings management between an internal and external appointed CEO, there is no difference of earnings management between CEO ages, there is no difference of earnings management use dependent on the size of the company, there is a difference of earnings management among industries.
b) Research conducted by Choi et al. (2012). The title is Earnings Management Surrounding CEO Turnover: Evidence from Korea. The variables in this study are CEO turnover (classified as four types depending on whether the departure of outgoing CEO is peaceful or forced and the incoming CEO is promoted from within or recruited from outside the firm), earnings management, firm performance, corporate governance, leverage, firm size, and sales. The results of this study showed that the departing CEO manages earnings upward only when he is forced to leave and succeeded by an insider. Earnings management in this case is through discretionary accruals. Second, the insider who replaces the CEO who is forced to leave takes a big bath using both discretionary accruals and discretionary expenditures. Third, the incoming CEO recruited from outside following the peaceful departure of predecessor tends to manage earnings upward using discretionary accruals. CEO turnover is systematically associated with firm performance and governance structure. Specifically, CEO turnover is negatively related to firm performance and CEO ownership regardless of the types of CEO turnover and positively related to the firm’s affiliation with business group and the presence of block shareholders.

c) Research conducted by Adiasih and Kusuma (2011). The title is Earnings Management at CEO Turnover in Indonesia. The variables in this study are CEO turnover (routine or non-routine) and earnings management. The results of this study showed that in the event of non-routine CEO
turnovers, the new CEOs practice earning management using discretionary accruals to lower earnings in the year of turnover. Evidence of earnings management in the event of CEO turnover is consistent with the theory that the new CEOs would minimize the earnings reported in the CEO turnover year by using 'earnings bath'. In addition, the old CEO in the event of non-routine CEO turnover does not perform earnings management in the last year before the turn. Therefore, the earnings manipulation is not an argument for non-routine CEO turnover.

d) Research conducted by Murphy and Zimmerman (1992). The title is Financial Performance Surrounding CEO Turnover. The variables in this study are CEO turnover, research and development (R&D), advertising, capital expenditure, accounting accruals and earnings, sales, assets, and stock price. The results of this study showed that outgoing CEOs approaching a known retirement or departure date make accounting or investment decisions to increase earnings (and earnings-based compensation) in their final years at the expense of future earnings. Outgoing CEOs in poorly performing firms threatened by termination make accounting or investment decisions in an attempt to cover up the firm’s deteriorating economic health. Incoming CEOs take a big bath, they boost future earnings at the expense of transition-year earnings by writing off unwanted operations and unprofitable divisions. The declines in the growth rate of R&D, advertising, and capital expenditures preceding departures are better explained by the overall poor
performance of the firm. To the extent that outgoing or incoming managers exercise discretion over these variables, the discretion appears to be limited to firms where the CEO’s departure is preceded by poor performance. The declines in sales, assets, and stock-price growth surrounding CEO departures primarily reflects not managerial discretion, but rather the fact that CEOs are more likely to leave when overall corporate performance is poor than when overall performance is high.
e)
Research conducted by Cella et al. (2014). The title is Earnings Management and CEO Compensation over Tenure. The variables in this study are tenure, compensation, CEO age, CEO origin, earnings management, firm size, leverage, market-to-book ratio, return on assets, share prices, number of shares outstanding, and institutional ownership. The result of the study showed that earnings management is highest in the early years and decreases monotonically over the CEO’s tenure. Compensation is positively associated with earnings management in the early years of a CEO’s tenure, but this relationship becomes negative over tenure, indicating that during the period of greatest uncertainty about a CEO’s ability, distorting earnings may pay off for some CEOs. Importantly, boards learn about CEOs’ ability over time and do not reward those who continue to distort reported performance. The relationship between reporting distortions and compensation varies based on CEO characteristics that capture uncertainty about ability and career concerns: earnings management is more strongly correlated with the
compensation of younger CEOs and those without a fixed term employment contract who may be at higher risk of being fired. These results indicate that boards adjust compensation in response to potential earnings distortions in the early years of a CEO’s tenure.

2.7. Hypothesis Development

Outside CEOs’ capabilities are not known by the market and the board of the company. They want to prove their ability that they can run the company well. They also want to establish a good reputation about themselves. They have a desire to prove that the company under their direction can achieve its main objective. They are worry about dismissal due to unsatisfactory performance, and therefore report earnings more aggressively than inside CEOs who already have established their ability and more concerned with preserving their reputations (Hermalin and Weisbach, 1998).

In addition to their stronger desire to prove their ability, outside CEOs tend to have lower survival expectations than inside CEOs. Prior study indicates that outside CEOs tend to remain in office for shorter times than their inside peers. Hostility from existing senior managers and the outside CEO’s own lack of firm-specific knowledge may work against an outside CEO’s efforts to initiate strategic changes to achieve initial objectives. A corporate board also could have overestimated the outsider’s abilities during the CEO selection process because it lacked sufficient information about the abilities of the external candidates (Kuang et al., 2014).
Outside CEOs have lower expectation to stay with the firm for the long term. Because they have lower expectation, they tend to act in ways that benefit them immediately. They tend to have short-term decision making that makes them more willing to increase the earnings management immediately after their appointment. They do not consider about the adverse consequences of their actions for the future. They are less likely to bear the long-term consequences of their actions because they will have already left the firm for their next appointment (Kuang et al., 2014).

Based on the argument—confronted with outside CEOs’ desire to prove their ability and their lower survival expectations—this study can formulate the hypothesis as follow:

H1: New outside CEOs will have positive impact on income-increasing manipulation.