CHAPTER I

INTRODUCTION

1.1 Background of the Study

Earnings is one of tools to measure the company's performance which investors and creditors give first attention because they use earnings to evaluate managements performance. Good earnings is useful in decision making, which have characteristics: relevance, reliability, and comparable.

One of the ways that management can do in arranging financial statements that have effects on earnings is earnings management. Earnings management is hoped to be able to increase firms' value in a certain period.

As we known that earnings is one of the important things in a company and it is used to measure the manager's performance in a certain period, many managers try to give a "good" earnings to the investors or shareholders to get their incentives. This motivation pushes the managers to do earnings management. Bagnoli and Watts (in Pudjiastuti and Mardhiyah, 2006) told that an earnings management practice is done in many companies.

Earnings management can occur because there is a conflict of interest between principal (owners/shareholders) and agent (management). They cannot meet their maximum utilities because management has more information about firms than shareholders and it causes asymmetry information that management may do accounting practices with earnings oriented to reach particular performance. Agency conflict causes opportunity for managements to report unreal earnings that will cause the firms value decrease in the future.

Gunny (2005) classified earnings management into three groups, they are: fraud accounting, accrual-based earnings management, and real activities manipulation. Roychowdhury (2006) and Graham et al. (2005) found that managers prefer real activities manipulation than accrual-based earnings management since Sarbanes-Oxley Act (SOX). According to Gunny et al. (2005), a shift from accrual earnings management to real earnings management due to several factors. First, the manipulation of accrual earnings management more often used as a central observation or inspection by auditors and regulators rather than decisions about pricing and production. Second, only focuses attention on accrual earnings management is risky because the companies may have limited flexibility to adjust accruals, such as limitations in reporting accruals discretionary (Graham et al. 2005). Cohen et al. (2008), Cohen and Zarowin (2010), and also Badertscher (2011) prove that firms make choices between real activities manipulation and accrual-based earnings management. Zang (2012) extends research on the trade-off between real activities manipulation and accrual-based earnings management. Zang (2012) proves that there is direct substitution between them after the fiscal year-end due to their sequential nature.

This thesis is replication of Zang (2012). Following Zang (2012), my study will focus in the two strategies of earnings management: accrual-based earnings management and real activities manipulation. The difference in this research is in research method. In Zang (2012), the research used data panel and the research was done in many range of time and in many range of data. Meanwhile, in this research, the researcher only observes in a year to see the overall effects of earnings management in that year. This research will focus at manufacturing companies listed in Indonesian Stock Exchange in year 2011. Data in this research will process by SPSS 16.

Real activities manipulation is a purposeful action to alter reported earnings in a particular direction, which is achieved by changing the timing or structuring of an operation, investment, or financing transactions (Zang, 2012). The idea that firms engage in real activities manipulation is supported by the survey evidence in Graham et al. (2005). They report that 80 percent of surveyed CFOs stated that, in order to deliver earnings, they would decrease research and development (R&D), advertising, and maintenance expenditures, while 55 percent said they would postpone a new project, both of which are real activities manipulation.

Unlike real activities manipulation, which alters the execution of a real transactions taking place during the fiscal year, accrual-based earnings management is achieved by changing the accounting methods or estimates used when presenting a given transaction in the financial statements (Zang, 2012). For example, changing the depreciation method for fixed assets and the estimate for provision for doubtful accounts can bias reported earnings in a particular direction without changing the underlying transactions.

The focus of this study is whether managers do real activities manipulation during the fiscal year and accrual-based earnings management at the fiscal year-end as substitute. This study is important because as mentioned by Fields et al. (2001), examining only one earnings management technique at a time cannot explain the overall effect of earnings management activities. In particular, if managers use real activities manipulation and accrual-based earnings management as substitutes for each other, then examining either type of earnings management activities in isolation cannot lead to definitive conclusions. Means it is important to know whether managers use the two techniques of earnings management and make a trade-off among them.

Real activities manipulation must occur during the fiscal year and is realized by the fiscal year-end, after which managers still have the chance to adjust the level of accrual-based earnings management. This timing difference implies that manager would adjust the latter based on the outcome of real activities manipulation. Hence, there is direct substitution between them; if real activities manipulation turns out to be unexpectedly high (low), then managers will decrease (increase) the amount of accrual-based earnings management they carry out.

As we known, manufacturing company is the biggest emitent that listed in Indonesian Stock Exchange. It means that it gives a big chance for the investors to give their investments. Then, manufacturing companies will be the focus of investors. In order to get many investors, there is a big opportunity for managers to do earnings management. Besides, manufacturing company is more complex than other companies. It accommodates many aspects of accounting. Means it is very easy for managers to do earnings management.

Based on this theory, the researcher is interested to research "**The Influence of Real Activities Manipulation on Accrual-Based Earnings Management (An Empirical Study at Manufacturing Companies Listed in Indonesian Stock Exchanges)**".

1.2 Problem Identifications

As related to the background of the study above, there are some identifications of the study as follows:

1. What are the motivations of managers do earnings management?
2. What is the impact of earnings management to the investors?
3. Is there any influence of earnings management on firms' value?
4. Do managers make trade-off the two methods of earnings-management (real activities manipulation and accrual-based earnings management)?

1.3 Research Concentration

Considering the above identifications, the scope of this study is to find out the empirical evidence of the influence of Real Activities Manipulation on Accrual-Based Earnings Management.

1.4 Research Question

As related to the above background, the question of the study is as follows: Is there any influence of Real Activities Manipulation on Accrual-Based Earnings Management (An Empirical Study at Manufacturing Companies Listed in Indonesian Stock Exchanges)?

1.5 The Objective of Research

The objective of the research is to find out the empirical evidence of the influence of Real Activities Manipulation on Accrual-Based Earnings Management at manufacturing companies listed in Indonesian Stock Exchanges (IDX) in year 2011.

1.6 Research Contributions

The contributions of the study are as follows:

a. For Researcher:

   This research provides a new knowledge to researcher related to earnings management.

b. For Academics:

   This research provides a new paradigm for students in studying earnings management, especially the two techniques of earnings management: Real Activities Manipulation and Accrual-Based Earnings Management.

c. For Next Researchers:

   This research can be a reference for related studies.