

CHAPTER I

INTRODUCTION

1.1 Background

For the last few decades, some researchers found that there is a decrease in earning quality (Jenkins et al., 2006). One thing, which can cause the decrease in earning quality, is something that can be done by the management, which is earning management. If management does earning management as an opportunistic action, it will make the quality of earnings decreasing (Levitt, 1998). The previous researchers also found that the earnings management may brings short term profit, but will bring negative impacts for the future performance of the company (Dechow and Schrand, 2004)

Earnings management has developed in variation, such as accrual earnings management and also real earnings management. The previous researches mainly focused on accrual such as done by Kothari (2001) and Fields et al (2001). But because of the development of research, the previous researchers found that the earnings management can be done also by real activities manipulation¹ (Roychowdury, 2006; Ratmono, 2010). Based on Graham et al. (2005), boards are more likely to manipulate earnings management through real activities rather than accrual. It happened because the accrual is riskier in attracting the auditor to check

¹ Real earnings management can be called as real activities manipulation (Roychowdury, 2006; Cohen and Zarowin, 2010)

deeper, rather than the real activities, which may covers decision about price and production (Graham et al., 2005). So, we can see that real earnings management is happening in business world. Specifically in Indonesia, some researchers found evidences that real earnings management has been done by public companies that listed in Indonesia Stock Exchange (Ratmono, 2010; Challen and Siregar, 2011).

Observing on the flexibilities and opportunities that can be utilized by the management to do some manipulation that could harm the company, Beasley et al. (2000) found that companies with weak corporate governance tend to do accounting manipulation. The other research that was done by Klein (2002) told that the board characteristics are related to earnings management by the firm. Another research that strengthened the importance corporate governance in reducing earnings management, Carcello et al. (2008) suggest that effective corporate governance can improve the quality of financial reporting. With good corporate governance, companies will be more transparent in information disclosure so that the investors will have more reliable information for taking decisions (Siregar, 2005).

Looking on corporate governance approach in Indonesia, is using two-tier system of corporate governance which means the structure consists of supervisory board and executive board. In Indonesia, there are non-governmental organizations that annually perform corporate governance grading practices for public companies, one of them is Indonesian Institute for Corporate Directorship (IICD). The ranking is done based on a research and survey toward corporate governance practices that produce scores corporate governance index. Previous

research found that corporate governance has not been successfully implemented in Indonesia (Sulistiyanto and Wibisono, 2003). Based on CG Watch market score: 2007 versus 2010 from Asian Corporate Governance Association (ACGA), shows that Indonesia placed on 10th rank out of 11 Asian countries. But there is an improvement from 2007 to 2010 about 3%. However, ACGA still states that Indonesia has weak corporate governance system.

There are very limited evidences from previous study done by Visvanathan (2008) who tried to investigate the relation of corporate governance and real earnings management. He found that only one characteristic proved which is the proportion of independent directors. But the research said that the relation of real earnings management and corporate governance still be an interesting question to be addressed to future research, because of the fact that real earnings management practice improves over time.

Therefore, through this research, we want to investigate the effect of corporate governance practices toward real earnings management. As far as we know, researches on the relationship of corporate governance to accrual earnings management are already widely held in Indonesia, but only a few has specifically examined on real earnings management. This research tried to answer the empty gap of the previous researches, which still questioned the association between corporate governance and real earnings management.

1.2 Problem Formulation

Based on the overview description above, we formulate a problem which is: Does the corporate governance practices give effect to real earnings management?

1.3 Purpose of the Research

Based on the problem formulated above, the purpose of the research is to identify the impact of corporate governance toward real earnings management.

1.4 Advantages of the Research

1) For the reader and other writer

From this research, another writer may have advantage of reference and idea of what is meant by corporate governance and real earnings management. Also, the other writer might gain knowledge if they want to conduct another research related to corporate governance or real earnings management. This research may add another benefit to the public as it gives them more knowledge about the relation between corporate governance practices and real earnings management in Indonesia.

2) For investors

This research could give some information to investors about the opportunity of real earnings management practices, which were done by the companies. Investors must be aware that there are possibilities that the financial reports contain earnings management practices. We hope that this research can give beneficial information to investors that want to make decision in investing.

1.5 Problem Limitation

Actually, this topic has a broad interpretation, so that we will limit the topic. This topic will be focusing on corporate governance practices and earnings management that happen in Indonesia. We use the Corporate Governance Perception Index year 2007-2009 from Indonesian Institute for Corporate Directorship (IICD) as a measure in calculating corporate governance variables in the main model. And for the sensitivity model, we use the size of board of commissioners, size of ownership concentration, and size of institutional ownership from year 2007-2011 to measure corporate governance variable. As for the measures to calculate earnings management through real activities, will be using calculation of abnormal cash flow operation, abnormal discretionary expenses, and abnormal production cost.

1.6 Writing Scheme

CHAPTER 1 INTRODUCTION

This chapter will include the overview of background of the research, problem formulation, purpose of the research, advantages of the research, problem limitation and writing scheme.

CHAPTER 2 THEORETICAL BASE AND HYPOTHESIS

DEVELOPMENT

This chapter will explain about the theories related to the thesis topic, for instance the concept of corporate governance and real earnings management, agency theory, and also the previous literature related to the topic and hypothesis development.

CHAPTER 3 RESEARCH METHODOLOGY

This chapter will consists of the explanation of population and samples of the research, data collection method, variables in this research, and analysis methods.

CHAPTER 4 EMPIRICAL FINDING AND ANALYSIS

This chapter consists of the overview and analysis of the research, which is to know if there is an effect of corporate governance toward real earnings management.

CHAPTER 5 CONCLUSION AND RECOMMENDATION

This chapter is the last chapter, which showing a conclusion about all the research and results analysis that have been done. In this chapter, there will be some recommendation that will add advantages to the next researchers in the future.