CHAPTER I

INTRODUCTION

1.1 RESEARCH BACKGROUND

Managers are always expected to manage the business as best as they can so that the company able to perform well. The company's performance will determine the inflow from the investors. The information whether the company's performance is good or not can be acquired from the financial report. Financial report contains accounting information which are valuable to the concerning users. That information can and often used as tools to read the company's condition and to predict the future of the company.

One of many information available and often times become the main information looked by the investors is earnings. Good earnings often taken as indication of good performance by investors. For investors accounting information is needed to analyse future earning of the company. Investors often focus on income information regardless of the procedures associated to generate such profit information.(Beattie, et al., 1994)

This substantial attention towards the amount of company's earnings provokes the management to be engaged in earnings management practice. Another motive of earning managements done by the management is relevant to agency theory. In agency theory, manager who function as the agent while owner function as principal have a different level of information or in other word called as information asymmetry. This information asymmetry happen because management who manage the internal of the company, further will be referred to as agent, know more about company rather than the owner or the principal. The desynchronization between two most prominent sides of the company result in a situation where management able to execute earnings management.

Generally, practitioners argue that earnings management inherently is the opportunistic behaviour of managers that manipulate the numbers in the financial report to achieve their desired outcome. Academicians on the other hand argue that earnings management happen simply because of the freedom managers have in choosing certain accounting method to be used in recording and compiling the financial information which will appear on financial report.

Earning management can take form in several basic forms. Earning maximization, earning minimization, taking a bath, and earning smoothing.Those types of income smoothing will differ based on the needs of each firm. The motives of why managers do earning management have a huge role in determining in what way the practice will be taken out. One example of earning management motive which is tax. Tax takes a part in the practice as well. Firms tend to avoid paying tax as best as they can, and that became another motive to do earning management. One way to push the tax liability as low as possible is to report the lowest income as the firm possibly can. That particular type of earning management which called earning minimization.

Earning management scandals has been recorded to happen in various companies across sectors in Indonesia. In 2010, as reported in Tempo.com, Indonesia Corruption Watch (ICW) reported three mining companies owned by Bakrie Group to Directorate General of Taxes. Indonesia Corruption Watch (ICW) suspected that reporting manipulation that is done by PT Bumi Resources Tbk., and it's subsidiaries since 2003-2008 have caused Indonesia to suffer financial loss amounted US$ 620,49 million.

Monitoring Division Coordinator and Budget Analysis of ICW, FirdausIlyas, stated that report manipulation happened in PT Kaltim Prima Coal (KPC), PT Arutmin Indonesia (Arutmin), and the parent of those two company, PT Bumi Resources Tbk (Bumi). Based on ICW calculation using several primary data including audited financial report, the result shows Bumi revenue in period 2003-2008 is lower as much as US$ 1.06 billion than what it should have been. As a result, it is estimated that Indonesia is suffering financial loss from Coal Production Fund (royalty) that is not paid for US$ 143.29 million (www.tempo.com).

Another case from mining company in 2011 is done by PT Ancora Mining Service (AMS). PT Ancora Mining Service was reported to Directorate General of Taxes by Forum Masyarakat Peduli Keadilan (FMPK) in suspicion of manipulationg financial report. Indication that there is a possibility of manipulation is seen because there is income amounted Rp. 34.9 billion but there is no movement in investment. Other than that, it was found that there is payment of interest as much as Rp. 18 billion while admitted to have no debt. FMPK also found evident of receivable amounted Rp. 5.3 billion with no apparent proof of transaction (www.republika.co.id).

PT Timah (Persero) Tbk., also caught in earning management mishaps. Chief of Lead Employee Association (IkatanKaryawanTimah abbreviated IKT) argue that board of directors had misled the public through media. For example, press release of financial report for first semester of 2015 that claimed the efficiency has resulted in positive performance. While in reality, PT Timahsuffer from loss as much as 59 billion rupiah.(okezone.com).

A case recentlyerupted, PT Bank BukopinTbk revised their financial report for the last three year, 2015, 2016, and 2017. Bank Bukopin revised their net income of 2016 to 183.56 billion rupiah, from 1.08 trillion rupiah. The biggest decrease is from provision and commission revenue which are generated from credit card revenue, which decrease from 1.06 trillion to 317.88 billion rupiah (detik.com).

Earning management behaviour can be explained through Positive Accounting Theory (PAT)three hypotheses according to Watts and Zimmerman (1986):

1. The bonus plan hypothesis

   When firm has the bonus plan to reward the manager, manager tends to choose the more beneficial accounting method for themselves, in which case able to move the income from future to be recognized in the present. This will increase present income which will then make it seem that manager has done a great job in current period that earn them the bonus.

2. The debt to equity hypothesis (debt covenant hypothesis)

   Firms which have high debt to equity ratio, managers tend to choose accounting method that can increase the income. High debt to equity ratio will result in difficulties to obtain capital from creditors.

3. The political cost hypothesis (size hypothesis)

   Big firms often have high political cost. Managers in these type of firms tend to choose accounting method that will defer the income from present to the future in order for them to reduce the reported earnings. Political cost emerges because of the firms' high profitability that can draw attention from media consumers.

In this research we will exclusively discuss about the more common form of earning management, if not the most, income smoothing. Management can push up or lower the income to reduce fluctuation or volatility of reported earning so that company is perceived as stable and has lower risks.

Good profit means a good performance in behalf of the company which draws the potential investors to invest their money in the said company. One way for companies to meet potential investors is through stock market. Stock price is heavily established by the supply and demand of the share. Since investors often time only concern about the amount of earning stated in financial report regardless on how the number gets there, the possibility of management to practice earning management is higher. Management are encouraged to stir the financial report into something more favourable that would better attract the potential investors to invest in the company. One of the reasons for management to smooth reported earnings according to Biedleman (1973) in Belkaoui (2000) that is cited in Arnan (2010), is the assumption that stable income stream capable of supporting a higher dividend rate than a variable income stream, and has favourable influence in the company's stock value because of the risk company reduced.

In the research done by Goel and Thakor in 2003, regardless the common motives of wanting to look stable, they found firms motives in doing income soothing is consequences of the managers trying to increase the firm's stock price by reducing the potential loss share-holder may suffer when they trade for liquidity reasons. Greater earnings volatility leads to a bigger informational advantage for informed investors over uninformed investors. In this case, uninformed investors are the current investors and may need to trade in the future for liquidity reasons, an increase in the volatility of reported earnings will magnify the shareholders trading losses. This will make those shareholders to wanting the management to smooth reported income.

Mining sector in Indonesia has been on the rise these past year and is predicted to still be favourable in the stock market in the future. Mining sector has a different characteristics than other sectors. To name a few, mining sectors requires high amount of investment, long term, high uncertainty and risk. Mining company needs huge capital to operate, like exploration of the resources. Therefore, companies will need to enter stock market to be able to absorb capital and strengthen the financial position.

The uncertainty of whether the highly cost and long term exploration will result in income or loss may become a motive for company to do income smoothing. The difference of accounting methods that can be applied in accounting for exploration and evaluation (E&E) which are full cost (FC) and successful efforts (SE) methods (Asekomeh, et al., 2008) also may enable the practice of income smoothing in mining sectors. The implication of these assertions is that income smoothing is possible by adjusting the impact on earnings of accruals through the expense/capitalize and amortize decision. The same possibility exists through real expenditures timing where the timing of E&E activities and costs produces a smoothing effect on earnings.

The above mentioned discussion motivates the researcher to study the issue on how income smoothing would affect the stock price in Indonesian stock exchange, particularly in mining sectors. There have been several researches preceding this research regarding the effect of income smoothing to stock price. Kristiyani (2013) has found that there is no significant effect between income smoothing practice to the stock prices. The research was conducted in Indonesia by using manufacturing company listed in Indonesian Stock Exchange in the period of 2008-2011. This result is parallel with the result Suryadi (2017) has found. Using the same population which is manufacturing company listed in IDX, in the period of 2011-2015, the researcher did not found the effect of income smoothing to the stock price. On the other hand, the hypothesis that earning management practice has positive and significant influence to stock price changes is supported by researches done by Hermansyah (2008) and Andriyani (2009).

Nafea et al. (2013) specifically stated that income smoothing as one of earning managements type, can increase stock price since the decreasing of investment risk.

1.2 PROBLEMS IDENTIFICATION

Based on the background described before, the problems to be studied are:

1. Does income smoothing practice happening in mining companies listed in Indonesian Stock Exchange in period 2012-2016?
2. Does income smoothing practice have significant effect on company's stock price?

1.3 RESEARCH PURPOSE

The purpose of the study is to investigate whether income smoothing is practiced in mining sector listed in IDX for the period of 2012-2016 and whether income smoothing practice affect the stock price of the said companies.

1.4 RESEARCH BENEFIT

The study is aimed to contribute into literature of earning management especially about income smoothing practice in Indonesia.

To be detailed, the breakdown of the benefit of the research can be as follows:

1. For author

    This research will increase author's knowledge regarding income smoothing practice in Indonesia especially in mining sector.

2. For investors

    This study will help investors in making decision regarding their investment. Investors will be able to include this study in consideration whether to invest in certain company. Income smoothing practice may not reflect the actual condition of the company and it might be misleading for investors.

3. For future studies

    For future studies, hopefully this study will contribute and provide information needed regarding income smoothing practice in Indonesia, especially in mining sector as reference for any subsequent study.

1.5 WRITING SYSTEMATIC

Chapter one will be the introduction chapter, it contains the background, problem definition, research purpose, research benefits, and writing systematic. In chapter two it will be the literature review about all related researches and materials for this research. Chapter three contain research methodology including the population taken, the sampling method, variables identification, data gathering method and data analysis method.