

EARNINGS MANAGEMENT PRACTICES: THE COMPARATIVE STUDIES BETWEEN SHARIAH INDEX (JII) AND CONVENTIONAL INDEX (LQ-45) IN INDONESIAN STOCK EXCHANGE

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ABSTRACT

Earnings management is a phenomenon that is difficult to avoid because the impact of using the accrual basis for preparation of financial statements. The practice of earnings management can be viewed from two different perspectives, They are opportunistic behavior (negative) and management actions that should be done (positive). Healy and Wahlen (1998) consider earnings management as an act of misleading and deceiving shareholders. This is due to management has an asymmetric information about the condition of the companies. The purpose of this study is to analyze the difference of earnings management between the shariah index (JII) and conventional index (LQ-45). These samples are 153 and 187 companies listed in Indonesian stocks exchange from 2004-2010 periods. The analysis used independent sample t-test. The result shows that the average value of accruals ($DACC_1$) on the companies listed in the conventional index is 0.8042210 and the average value of accruals ($DACC_2$) on the companies in the shariah index is 0.098318. Statistical test shows that there is not significant differences in earnings management practices (DACC) between companies in the shariah index and conventional index (prob.value = 0.335). It means that earnings management practices which tend to increase the profit made by the companies in the conventional index more than the companies in the shariah index. Earnings management perspective used in this study is opportunistic perspective. For further research, earnings management needs to be reviewed from the other perspective, such as efficiency perspective and a positive perspective.

Keywords: Earnings management, Conventional index, Shariah index,

INTRODUCTION

Earnings management is a phenomenon that is difficult to avoid because it is the impact of the used accrual basis in the financial statements preparation. In practice, managers can select appropriate accounting policies of financial accounting standards. Therefore, it is reasonable if the managers choose policies to maximize their utility and firm market value. Scott (2006) defines earnings management as an accounting policy choice by the manager in order to achieve certain goals.

Earnings management occurs when management uses certain decisions in the financial statements and transactions to alter financial reports as the basis for the performance of a company that aims to mislead the owner or shareholder or to influence the outcome of contractual rely on accounting numbers reported (Healy and Wahlen 1998). Earnings management is an intervention with the specific intent of the financial reporting process to maximize private gain (Schipper, 1989). Its definition means that earnings management is opportunistic behavior of managers to maximize their utility. Managers do earnings management by selecting a specific accounting methods or policies to increase profits or lower profits. Managers can increase profits by shifting earnings periods into a period now and the manager can reduce profits by shifting the current period to the later periods.

Some researchers have found that the asymmetry of information may affect earnings management. Agency theory implies the existence of information asymmetry between managers as agents and owners (in this case is the shareholder) as a principal. Information asymmetry arises when managers more aware of internal information and the company's prospects in the future than the shareholders and other stakeholders. The presence of information asymmetry is considered as the cause of earnings management (Richardson, 1998) The existence of information asymmetry will encourage managers to present information that is not true especially if the information relates to measuring the managers performance. Flexibility of management to conduct earnings management can be reduced by providing more quality information to outside parties. The quality of financial statements will reflect the level of earnings management (Aprimaya, 2006).

Research on earnings management has been widely applied in Indonesia, namely by Midiastuty and Machfoedz (2003); Veronica and Bakhtiar (2004); Wedari (2004); Boediono (2005); Kusumawati (2005); Veronica and Main (2005); Rahmawati, Suparno and Qomariyah (2006); Hanafi (2006); Nasution and Setiawan (2007); Ujijantho, Arief and Scout (2007); and Herawaty (2008). The whole object of these researchs using the company listed in the conventional index

The launching of Shariah index in the Indonesian capital market is very interesting for researchers, especially in earnings management practice. In Indonesia, the research on the performance of JII has been done by some researchers. Their research results showed that the stocks in the group of JII is better than LQ 45. Cahyaningsih, Suwardi and Setiawan (2008) conducted a study on the comparative performance of mutual funds Shari'ah and conventional mutual funds. The results showed that the performance of conventional mutual funds worse than the performance of Islamic mutual funds and portfolio managers of mutual funds performance in shari'ah better than the performance of conventional mutual fund portfolio. Another test performed Hanafi (2006), through the cost of capital approach to stock JII compared with a group of stocks LQ 45. His results showed that the cost of capital stock is lower than the LQ JII 45. Cost of Capital revealed a number of assumptions that a lower level of risk, lack of information asymmetry and agency costs are lower in JII companies so that investors are not too demanding rates of return.

This study aims to analyze how the differences in earnings management practices among companies listed in the index Shari'ah (JII) and conventional index (LQ-45) in the

Indonesia Stock Exchange. Some previous research in Indonesia, did not examine the differences in earnings management practices on both indexes. The period used in this study is 2004 – 2010, base on the a formal launch of the capital market with the principles of Islamic Shari'a held on March 14, 2003 with the signing of a memorandum of understanding between Bapepam and the National Sharia Council - Indonesian Ulama Council (DSN-MUI).

THEORITICAL FRAMEWORK AND HYPOTHESIS

1. Positive Accounting Theory

Positive accounting theory related to the prediction, is an action by the company's accounting policy choices and how companies respond to proposed new accounting standards. Positive accounting theory provides insights on how companies conduct organizational efficiency in order to maximize their company's survival prospects.

Positive accounting theory explains that the accounting procedures can't be used to the same company. Instead the company should be given the freedom to choose one of the alternative procedures available to minimize costs and maximize enterprise value contracts. The flexibility granted to the company is also very useful in circumstances where there is environmental change that caused the cost of changing the company's contract.

However, because the managers are given the freedom to choose accounting procedures of the procedures available, the manager will do something called positive accounting theory as an act of opportunism. Opportunistic action is an action in which managers choose accounting policies that benefit him. Thus the accounting policies can be influenced by two factors. The first factor is the selection of accounting policies for efficiency purposes, namely to minimize costs and maximize enterprise value contract. The second factor is the selection of accounting policies for managers to act opportunistically.

Earnings management behavior can be explained through Positive Accounting Theory (PAT) and Agency Theory. PAT has three hypotheses that can be used as the basis for understanding earnings management measures formulated by Watts and Zimmerman (1986), which was reaffirmed by Scott (2006). **First, the bonus plan hypothesis.** This hypothesis states that managers at firms with bonus plans tend to use accounting methods that would increase current income. Companies that have a bonus plan, company managers would prefer accounting methods that can shift profits from the future into the present, so as to increase current earnings. This is because managers prefer higher wages to the present. In the bonus contracts known two-term, they are *bogey* (the lowest income level to get the bonus) and *cap* (the highest income level). If earnings are below the bogey, there is no bonus earned, and if profit is above the cap, managers will not receive an additional bonus. If earnings are below the bogey, managers tend to reduce profits for obtaining a larger bonus in the next period, it also done, if profit is above the cap. So, only if net income is between bogey and cap, managers will try to raise the company's net income.

Second, the debt covenant hypothesis. This hypothesis states that the company has a high debt to equity ratio, managers tend to use accounting methods that will increase revenue and profits. **Third, the political cost hypothesis.** This hypothesis states that at a large company that has a high political cost, managers will prefer to suspend the accounting method reported earnings from current period to future periods so as to minimize reported earnings. Political costs arise due to the high profitability of companies that can attract the attention of the media and consumers.

2. Agency Theory

Jensen and Meckling (1976) stated that the agency relationship is a contract between the manager (agent) and the investor (principal). Conflicts of interest between owners and agents do not occur because the possible agents always act in accordance with the interests of principals, thus triggering the agency costs. The emergence of earnings management can be explained by agency theory. As agents, managers are morally responsible for optimizing the benefits for the owner (principal) and reciprocally, they will receive compensation in accordance with the contract. Thus there are two different interests in companies which each party seeks to achieve or maintain a desired level of prosperity.

Eisenhardt (1989) stated that the agency theory of human nature using three assumptions: (1) generally, humans make selfishness (self interest), (2) humans have a limited power of thought regarding the perception of the future (bounded Rationality) and (3) human always avoid risk (risk averse). Based on the assumption that human nature as a human manager will act opportunistic, and give priority to personal interests.

Managers of the company more aware of internal information and the company's prospects in the future than the owners (shareholders). Managers shall provide signals about the condition of the company to the owner. The signal can be done through the disclosure of accounting information such as financial statements. Financial statements are important for external users primarily because they are in the greatest uncertainty. Imbalance control of information will lead to the emergence of a condition referred to as asymmetric information.

Asymmetry information between management (agent) and owner (principal) can provide an opportunity for managers to make earnings management in order to mislead the owners (shareholders) on the economic performance of companies. Richardson (1998) showed a positive relationship between information asymmetry and earnings management.

3. Earnings Management

Scott (2006: 344) defines earnings management as follows “*Given that managers can choose accounting policies from a set (for example, GAAP), it is natural to expect that they will choose policies so as to maximize their own utility and/on the market value of the firm*”. From this definition, the earnings management is an accounting policy choosed by the manager from accounting standards that naturally and can maximize their utility or the enterprise market value.

Schipper (1989) defines earnings management as an intervention with the specific purpose of external financial reporting process deliberately to gain some personal advantage. Fischer and Rosenzweig (1995) defines earnings management as an act of a manager by presenting a report that raise (lower) profit for the period of the business unit that became his responsibility, without causing an increase (decrease) the economic profitability of such units in the long run. Meanwhile, according to Healy and Wahlen (1999), earnings management occurs when managers use considerations (judgment) in financial reporting and the preparation of transactions to alter financial reports, in order to manipulate the size (magnitude) of income to some stakeholders about the economic performance of the company or to influence the outcome agreement (contract) which depends on the accounting figures reported.

Healy and Wahlen (1999), states that the definition of earnings management contains several aspects. The first, intervention of earnings management from financial reporting can be done with the use of judgment, for example judgment needed in estimating the

number of economic events in the future to show in the financial statements, such as the estimated economic life and residual value of fixed assets, the responsibility for pensions, deferred taxes, losses receivables and a decrease in asset values. Besides, the manager has the option of accounting methods, such as the depreciation method and cost method. Secondly, the purpose of earnings management to mislead stakeholders about the economic performance of companies. This is occurs when management has access to information that it is not accessible by outsiders. Earnings management is intervening process of external financial reporting in order to make benefit themselves. Earnings management is one factor that can reduce the credibility of financial reporting, it increases the bias in the financial statements and can interfere the trust of financial statements users because the profit rate was engineered as a number of profit without engineering (Setiawati and Na'im, 2000).

Until now, earnings management is a controversial area of financial accounting. The practice of earnings management can be viewed from two different perspectives, namely as a wrong action (negative) and management actions that should be (positive). Healy and Wahlen (1998) consider earnings management as an act of misleading and deceiving shareholders. This is due to management have asymmetric information about the condition of the company. Another view assumes that earnings management is an effort to positive action, such as research conducted by Tucker and Zarowin (2006), the results showed that changes in stock prices run on the company with a higher income smoothing contains more information about future earnings than changes in stock prices of companies with lower income smoothing. Widarto (2004) states that earnings management is considered unethical, even a form of manipulation of information so misleading. When the company practices earnings management, earnings picture is no longer able to fairly represent the performance of the company, which will reduce the reliability of profit itself. As such information becomes less relevant earnings (Whelan and McNamara, 2004). Managers make earnings management actions can be worse because it can mislead users of financial statements and information can be categorized as an act of fraud are unethical. Anyone who uses financial statements that contain elements of earnings management is prone to misinterpretation, manipulation or deliberate deception (Burns and Merchant, 1990).

Hypothesis

The practice of earnings management can be viewed from two different perspectives, namely as a wrong action (negative) and management actions that should be (positive). Healy and Wahlen (1999) consider earnings management as an act of misleading and deceiving shareholders. This is because management has the information asymmetry regarding the condition of the company. Another view assumes that earnings management is an effort to satisfy shareholders. Earnings management done to maximize firm value when there is information asymmetry between managers and owners. This can reduce the risk perception investors due to uncertainty in future returns that is expected to improve shareholder value. Based on Halim, Meiden and Tobing (2005) research by using 34 companies as samples, from 2001 to 2002, shows that manufacturing companies including LQ-45 index do earnings management practice. Information asymmetry, the performance, leverage and firm size effect on earnings management.

In Indonesia, the research on the JII performance has been done by some researchers, The results showed that the stocks in the group JII is better than LQ 45. Cahyaningsih, Suwardi and Setiawan (2008) conducted a study on the comparative performance of mutual funds Shari'ah and conventional mutual funds. The results showed that the performance of Shari'ah mutual funds better than the performance of conventional mutual funds and portfolio managers of mutual funds performance in shari'ah better than the performance mutual fund portfolio manager of conventional. Hanafi (2006), the cost of

capital approach to JII stocks compared with a group of LQ 45 stocks. The result showed that the cost of capital stock in JII is lower than the LQ 45. Cost of Capital r shows the existence of some assumptions of a lower level of risk, lack of information asymmetry and agency costs, so investors are not too demanding rates of return. Based on the literature above, the hypothesis of this study is:

Hypothesis: The average earnings management value in the conventional index (LQ45) was higher than in Shariah index (JII)

RESEARCH METHOD

This research is designed to analysis the difference of earnings management practices conducted in public companies listed in the index LQ 45 and JII. The population is all companies listed on the Indonesia Stock Exchange. Sampling method uses purposive sampling in order to obtain a representative sample with the specified criteria. The criteria used to select the sample are:

1. The companies listed on the Indonesia Stock Exchange in group of Jakarta Islamic Index (JII) and LQ 45 during the period 2004-2010.
2. The companies published annual report for the period December 31, 2004 to 2010 and stated in rupiah (Rp)
3. Data is available for analysis completely.

The data were collected from financial statements (annual report) of listed companies in Indonesia Stock Exchange during the period 2004 to 2010. It collected from Indonesian Capital Market Directory (ICMD) and the website each company. The variable is earnings management (DACC) and calculated by the Modified Jones Model. We select the modified Jones model because this model is regarded as the best model in detecting earnings management compared with other models as well as give the most powerful (Dechow et al., 1995; Sutrisno, 2002).

The steps in calculating discretionary accruals as follows:

$$\begin{aligned} TACC_{it} &= EBXT_{it} - OCF_{it} \\ TACC_{it}/TA_{i,t-1} &= \alpha_1 (1/TA_{i,t-1}) + \alpha_2 ((\Delta REV_{it} - \Delta REC_{it})/TA_{i,t-1}) \\ &\quad + \alpha_3 (PPE_{it}/TA_{i,t-1}). \end{aligned}$$

From the regression equation above, NDACC (non discretionary) can be calculated by re- enter the coefficients alpha (α) is as follows:

$$\begin{aligned} NDACC_{it} &= \alpha_1 (1/TA_{i,t-1}) + \alpha_2 ((\Delta REV_{it} - \Delta REC_{it})/TA_{i,t-1}) \\ &\quad + \alpha_3 (PPE_{it}/TA_{i,t-1}) \end{aligned}$$

Description:

- $TACC_{it}$: Total accruals company i in t period
 $EBXT_{it}$: Earnings Before Extraordinary Item company i in t period
 OCF_{it} : Operating Cash Flows company i in t period
 $NDACC_{it}$: Non discretionary accruals company i in t period
 $TA_{i,t-1}$: Total assets company i in $t-1$ period
 ΔREV_{it} : Revenue exchange company i in t period
 ΔREC_{it} : Receivable exchange company i in t period
 PPE_{it} : Fixed assets (gross) company i in t period

Then, the discretionary accruals value can be calculated by these formula:

$$\begin{aligned} DACC_{it} &= (TACC_{it}/TA_{i,t-1}) - NDACC_{it} \\ DACC_{it} &: Discretionary accruals company i in t period \end{aligned}$$

$TACC_{it}$: Total accruals company i in t period
 $TA_{i,t-1}$: Total assets company i in $t-1$ period
 $NDACC_{it}$: Non discretionary accruals company i in t period

Data Analysis Techniques

First, the data will test by the normality data before testing hypothesis. Testing the normality data use Kormogorov-Smirnov test with the significance level 5%. The hypothesis (H1) performed by independent samples t-test. The test is performed to analysis if there is a significant difference between discretionary accruals (DACC) in listed companies in the Shari'ah index (JII) and conventional index (LQ45). The decision-making of this test is looking at the probability value. If the value $asymp.sig$ (2-tailed) > 0.05 , so the hypothesis is rejected and vice versa if the probability $asymp.sig$ (2-tailed) < 0.05 , the hypothesis is supported by the data.

RESULT AND DISCUSSION

Research data derived from audited financial statements (annual report) from listed companies in the index of sharia (JII) and the conventional index (LQ-45) in the Indonesia Stock Exchange (BEI) during 2004-2010 period. The sample is obtained as follows:

Table 1 The research sample

Shari`ah Companies (JII)	
companies listed in JII during 2004-2010 period	163
companies have data incompletely	(10)
JII sample	153
Conventional companies (LQ-45)	
companies listed in LQ-45 during 2004-2007 period	220
companies have data incompletely	(33)
LQ 45 sample	187
Total sample can be analyzed	340

Sumber : www.idx.co.id

The results of descriptive statistics showed that the average discretionary accruals for companies listed in the shari'ah index is 0.098318 and the conventional index is 0.8042210. The discretionary accruals value is positive. It shows that during 2004 – 2010 period, companies which listed in the shari'ah index and conventional index act the pattern of earnings management by maximizing its profits. These results supported previous research by DeFond and Jiambalvo (1994); Sweeney (1994); Peltier-Rivest (1999); Jaggi and Lee (2001); Rosner (2003); Djakman (2003); Sham (2004); Andriyani (2004); and Kusumawati and Sasongko (2005) who provide empirical evidence regarding the pattern of earnings management in the form of increasing reported earnings.

The result of normality test for the discretionary accruals value appears that Z value is 6.315 and prob value is 0.00 less than 0.05. It indicates data not normally distributed. But the number of samples as much as 340 samples, so it can be concluded that the assumption of normal data meet the central limit theorem ($n > 30$), Hypothesis testing is performed to test whether there are differences the amount of earnings management between companies listed in the shari'ah index and conventional index. The results of statistical analysis showed that the average discretionary accruals under management companies in LQ 45 (0.8042210134) is higher than the average

discretionary accruals under management companies in JII (0.0983180392). However, the results of independent sample t-test showed that there was no difference in the value of discretionary accruals between firms belonging to the Islamic index and conventional index. The results of this analysis can be showed in table 2 below.

Table 2 Independent Samples test

Variable	F	Sig.	Sig. (2-tailed)
DACC			
Equal variances assumed	10.787	.001	0,335
Equal variances not assumed			0,287

Source : secondary data

Levene test (F test) was conducted to test whether there is a significant variance difference between companies in the shari'ah index and the companies in the conventional index. The probability of error is $0.001 < 0.05$, it means that there are significant variance differences between sample firms in the Islamic index and conventional index. Based on the results of the Levene test, the t test for two independent samples using the Equal variance not assumed. It means that variance sample firms is different. The results of the analysis with independent sample t-test showed that there was no difference the amount of earnings management in companies listed on the LQ 45 and JII index. The significant value is $0.287 > 0.05$. So the hypothesis was rejected. Nevertheless, the average DACC value for companies in the conventional index is higher compared to the shari'ah index. It means that earnings management practices tend to increase earnings more done by the companies in the conventional index than companies in the shari'ah. This finding is consistent with the previous researchs by Cahyaningsih, Suwardi and Setiawan (2008) and Hanafi (2006) which showed that companies listed in the Islamic index are more ethical than companies listed in the conventional index.

CONCLUSIONS

Based on the hypothesis testing, it can be concluded that there was no difference value of earnings management in companies listed in the shari'ah index (JII) and conventional index (LQ45). The significant value is $0.287 > 0.05$. The average value of earnings management (DACC) in companies listed in the conventional index is higher than DACC from companies listed in Shari'ah index. They are 0.0983180392 and 0.8042210134. The patterns of earnings management during the 2004-2010 period tend to increase the profit value. Earnings management perspective used in this study is opportunistic perspective. For further study, it should be reviewed from the other perspective, such as efficiency perspective. Efficiency perspective states that the manager made a choice of accounting policies to provide better information about the cash flow and to minimize the agency cost arising from conflicts of interest between stakeholders and managers (Jiambalvo, 1996). Model to calculate the discretionary accrual in this study used Jones model modified, so it should be used another model as a proxy of earnings management, such as cross-sectional abnormal accrual model (Peasnell et al., 1998), absolute discretionary accrual (Rajgopal et al., 1999) and it is also necessary to test which model is most appropriate for conditions in Indonesia capital market.

Acknowledgment : This paper is part of *Hibah Pasca-I* research that is funded by DP2M, Dirjen Dikti, Kementerian Pendidikan Nasional Republik Indonesia, DIPA Nomor : 0541/023-04.1.01/00/2011,

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