

# CHAPTER I

## INTRODUCTION

### 1.1. Background of the study

In the capital market, investors (individual or institutions) expected that the stock value would be increasing or gain return. Commonly, the increasing of the stock price will give the investors opportunities to gain return. Consequently, investors anxious that the stock price will be increasing in the future, which the selling price of the stock is higher than the buying prices so that investors can obtain return from the quarrel.

Besides that, investors will be facing a risk that the stock price will be in declining stage. This phenomenon should be considerate by investors especially on predicting the future stock price. Fundamentally, the increasing of stock price is influenced by the ability of company assign the return for the investors. Return has tight relation with earning. Thereby, future earning is the main determinant of future stock prices. These shown by Fischer and Jordan (1991) that earning influence the stock prices.

Sloan (1996) explained there are two components of earnings; accrual component and cash flow component. Sloan (1996) indicated that the accrual component of earnings exhibits lower persistence than the cash flow component of earnings. Means that, cash flow from operations predicts future profitability more strongly than do accruals. A neglect of this distinction would cause investors to be too optimistic about the prospect of firms with high accruals and too pessimistic about the prospects of firms with low accruals. As shown in Sloan (1996), the stock price act as if investors “fixate” on earnings, the investors fail to distinguish fully between the different properties of the accrual and cash flow components of earnings. Consequently, firms with high (low)

levels of accruals experience negative (positive) future abnormal stock return that is concentrated around future earnings announcements. This pattern, known as the accrual anomaly, which is controversial because it conflicts with the claim of the efficient market hypothesis that all public information is correctly impounded into prices so that impossible for investors to gain excess return.

The first research introduced by Sloan (1996) reported that the accrual anomaly exists in the U.S stock market. Further, the researchers (Collins & Hribar, 1999; Bradshaw, Richardson, & Sloan, 2001; Chen & Cheng, 2002) have sought to confirm or extend the presence of accrual anomaly in U.S. stock market. Xie (2001) confirms Sloan's results and decomposes total accruals into normal accrual and abnormal accrual components by using Jones (1991) model. The authors indicate that investors overprice total accrual components and mispricing in abnormal accruals of U.S stock market. Hence, the persistence of accrual anomaly persists and the magnitude has not declined over time in U.S market and its conjecture that individual and institutional investors will learn more about it and arbitrage in anomaly way to get an abnormal return. Lev and Nissim (2006) found that institutional investors tend to react to accruals information than individual investors.

Moreover, the presence of the accrual anomaly is investigated internationally, as well. Pincus, Rajpogal, and Venkatachalam (2007) examined whether accrual anomaly generalize to the other countries outside U.S, it's showed that the accrual anomaly more likely to occur in countries with common law legal tradition than code law and more extensive use of accrual accounting countries such as Australia, Canada, United Kingdom, and United States. In the other hand, Leippold and Lohre (2010) demonstrate the existence of accrual anomaly in both common law countries (Australia, Canada, Hong Kong, Ireland, Thailand, United Kingdom, United States) and code law countries

(Denmark, France, Germany, Italy, Japan, Switzerland). Thus, the presence of accrual anomaly in international issues also found by Lafond (2005) in both common and code law countries.

Furthermore, Ozkan and Kayali (2015) reported that the full sample of the research do not indicate of mispricing in the component earnings on Borsa Istanbul. After the authors exclude the loss firms from the sample, mispricing of total accruals and its components thus presence of accrual anomaly is revealed. In Borsa Istanbul, the trading strategy based on total accruals of profit firms, investors may generate abnormal return of 18.50%. The trading strategy requires taking a long (buy) position in the portfolio consisting of stocks of firms reporting a relatively low level of total accruals and a short (sell) position in the portfolio consisting of stocks of firms reporting a relatively high level of total accruals (Sloan, 1996). In addition, the prior research above in line with the finding of Clinch, Fuller, Govendir, and Wells (2012) that the evidence of accrual anomaly also found in Australia stock market, which the distinct that in Australia stock market the returns to the hedge-portfolio formation decreasing overtime in 3-year period and only significant on the first year. But, the presence of accrual anomaly is not proven in Brazilian stock market (Cupertino, Martinez, & Costa, 2012) and China stock market (Li, Niu, Zhang, & Largay, 2011).

Kho and Kim (2007) examined that the accrual anomaly reflects the mispricing of accruals and not related with any risk factor in Korean stock market. Mispricing of accruals on the stock return occur because investors pay attention only on one component of earnings. These stimulate another research to examine whether the accrual anomaly reflects market mispricing or can be captured by identifying the risk factors in stock returns. Hirshleifer, Hou, and Teoh (2012) found that the accrual characteristics that predicts returns rather than the accrual factor loading (risk) and shown that the accrual

anomaly weakened over time and increase in volatility in U.S. stock market. Moreover, Ohlson and Bilinski (2015) confirmed that accruals do not reflect risk and the accrual anomaly is indeed an “anomaly”.

In other hand, the research regarding the accrual anomaly is not much investigated in Indonesia stock market. Indonesia Stock exchange experienced the accrual anomaly but it only clearly seen in the specific period of 2005 and 2006 but it does not found in 2003 and 2004 (Toha & Harahap, 2012). On the contrary, Aunilah and Ghofar (2014) found there are no occurrences of accrual anomaly in Indonesia stock exchange in the period of 2002 until 2007.

Further investigation on the accrual anomaly is needed especially in Indonesia stock exchange, which are only limited research investigate on this topic. This research attempts to investigate the existence of the accrual anomaly in Indonesia Stock Exchange in the period 2013-2015, which yet found authors examine during this period from prior research.

## **1.2. Problem Formulation**

Based on the background of the study, the reason why this research is important to be conducted because it's still needed to further investigate the appearance of the accrual anomaly during the research period in Indonesia Stock Exchange.

## **1.3. Research Question**

Based on the problem formulation above, accordingly the research questions of this research are:

1. Does the accrual anomaly phenomenon exist in the Indonesia Stock Exchange?

#### **1.4. Research Objective**

This research is aimed to:

1. Examine the existence of the accrual anomaly in Indonesia Stock Exchange

#### **1.5. Research Contributions**

By doing this research, hopefully will give some advantages as follows:

1. Theoretical Contributions

In theoretical, this research expected can give the contributions in the finance theory specifically regarding the accrual anomaly in stock market. The result of this research expected can be the supplement of new inference relevant to the previous researches that examine the relevant topic regarding the accrual anomaly.

2. Practical Contributions

This research expected can be a guidance or consideration for the investors in setting their investment decision. Hence, the existence of this research can help the investors to choose the appropriate investment trading strategy in the interest of avoiding the bias occur from the anomaly when valuing the stocks, so the investors will not suffer the loss.