CHAPTER I

INTRODUCTION

1.1 Background of Study

Financial Statements provides vital information regarding its financial wealth. It gives insight into its performance, operations and reflects a true picture of the entity itself. The users of financial statements are not only the employees but also shareholders, lenders, government, and the public. It is very important for shareholders as it is one of the major ways to know the condition of their investment. The profitability of the company can be observed through these financial statements.

Management of a firm has the responsibility to prepare financial statements. In which, these situations lead to the fact that the managers tend to have more capabilities to prepare and report the accounting transactions based on how the management would like the results to be reported. In other words, the management has the ability to decide how much of the profit will be given as dividends to the shareholders and also how much will be reinvested as retained earnings in the company.

The flexibility of accounting standard gives room for the management to adjust earnings through managing accruals. This activity is called Earning Management. It is an arrangement made by the managers to window dressed the reported earnings in financial statements. Earning management should not be regarded as a fraudulent act as it occurs within the framework of accounting procedures. Hence, it can also be defined as reasonable as it is prepared with the purpose to create stability in terms of earnings (Learning, 2016).

Due to this issue, earning management becomes a debate subject for academicians and also for practitioners. The reason is, the managers have many incentives to manage the earning to meet the expectations of analyst and to show that the company is not risky to be invested. Many of the financial scandals and corporate failure around the world happened were the result of the earning management due to excessive greed of few individuals. For instance: The WorldCom scandal, where the CEO manage the earnings by recording the expenses under investment accounts. By these activities, the CEO is able to exaggerate the profits around $1.4 billion when it is actually net loss. This activity gives image to the investors that sometimes when things seems too good to be true, they might just be. To put it differently, this case shows that earning management can be made by management to gain fake public recognitions and deceive the shareholders.

Another case happened is Enron Company which is the largest energy trading company in the world in 2001. This company managed their earnings through taking advantage of accounting standards. In which is intentionally removing the losses and the debts off from balance sheet. Regarding how it did it, the company first recorded all projected profit from a project even before the project has finished. If that project did not make profit as it is projected, Enron did not record it as a loss directly. It recorded it under Off Balance Sheet Special Purpose Vehicle (SPV), which means that the loss would be unreported instead. However, the main purpose of this SPV is actually for a firm to make its obligations secure even if the parent company goes bankrupt. It is only Enron taking this as his tool to manipulate its loss and debts (Oversized, 2017).

The table below shows the conditions of several companies during the period 2017 to 2018. The calculation of earning management is done by measuring the discretionary accruals, which shows that when the Discretionary Accruals decrease, the dividend payout ratio also decrease. As can be seen on Gudang Garam Tbk, HM Sampoerna Tbk and Mandom Indonesia Tbk on the table below.

Table 1.1 Earning Management and Dividend Payout Ratio During 2017-2018

Company	Year	Earning Management	Info	Dividend Payout Ratio	Info
Gudang Garam	2017	- 449.232.000.000	Decrease	0,65	Decrease
Gudang Garam	2018	-3.431.632.000.000		0,64	
HM Sampoerna	2017	- 2.705.781.000.000	Decrease	0,99	Decrease
HM Sampoerna	2018	- 6.655.065.000.000		0,92	
Mandom Indonesia	2017	- 184.582.046.250	Decrease	0,46	Decrease
Mandom Indonesia	2018	- 20.317.991.459		0,48	
Kalbe Farma	2017	444.934.874.538	Decrease	0,43	Increase
Kalbe Farma	2018	- 273.513.984.702		0,48	
Kimia Farma	2017	326.466.727.807	Decrease	0,16	Increase
Kimia Farma	2018	143.538.257.057		0,24	
Multi Bintang	2017	10.555.999.999	Decrease	0,81	Increase
Multi Bintang	2018	- 187.708.000.001		0,92	

Source: Prepared by the Writer (2019)

On the contrary, as can be seen on the table above, there are several cases happened in other companies, which shows that when the discretionary accruals decrease, the dividend payout may increase also. For instance: the cases happened on Kalbe Farma Tbk, Kimia Farma Tbk, and Multi Bintang Tbk.

This is one of the reason also for the writer to find out whether the earning management really does give impact on dividend policy. From investors' perspective, they only expect two forms of return by investing in a firm, first is the Capital Gains, in which the investor expects an increase in the market value of the common stock over time. Another one is Dividend. The decision to pay out dividends from a firm is an element of corporate financial decisions that is served to give return to the shareholders for the risk of investing their money.

Generally, investors rely on dividend payments as a source of income. It is as if an investor who holds a significant share of a firm, the income that they expect the most would not be on how much the income will be when they sell the share. But the cash inflow that could arise from it instead, which is through dividends. The typical shareholders of mature corporations generally prefer to receive steady dividends. To determine how much of earnings should be distributed in form of dividend and the amount to be kept for future growth, the financial manager needs to set a Dividend Policy. Dividend policy is a set of rules, the base that the company use to mitigate agency conflict which may arise due to failure to pay the dividend as well as making a reasonable investment.

A firm's dividend policy is influenced by several factors, which are investment opportunities, tax consideration, and expected future earnings. This matter has been researched by many researchers, where earning management are one of the factors.

Besides that, Jeffry L Huston (2015) stated that the company that tends to pay more dividends is the type of large companies that has predictable profits. This is because this type of companies seek more on how to maximize the shareholder wealth instead of capital gain. Companies that are observed to pay out stable dividends are Banks and Financial, Mining, Agriculture, Consumer Goods, and Utilities (Huston, 2015).

On the other hand, Startup companies tend to pay less dividends.. Since those types of companies need more fund as they are in the position which need to develop in many aspects, including business expansion and operational activities. Even sometimes in mid-stage companies avoid paying out dividends, if they are aiming for expansion. To sum up, large companies generally pay dividends, while smaller companies do not. Thus, the size of a firm can be one of the considerations for a firm to decide on its dividend policy. Hence, this research treats the Firm Size as a control variable.

Besides firm size, the return on equity is also treated as control variable. Return on equity is one of profitability ratios that are measured through the earnings of the company. It is a ratio that measure the rate of return of shareholders and at the same time shows the ability to generate profits that can be shared with shareholders. In other words, ROE shows whether the company effectively uses equity to generate profits. The greater the values of return on equity, the higher the expected return from investors tend to be. High value of return on equity shows that the company is more profitable. Because dividends are distributed from the net profits obtained by the company, the amount of profits will affect the amount of dividends to be distributed. Thus, the return on equity becomes the control variable in this research.

A lot of research has been done on dividend policy. However, the consensus has not yet been solved. Hence, further research is needed to make a clear consensus. This study is one of the effort to contribute in this issue. Thus, this research paper will discuss **"The Impact of Earning Management on Dividend Policy with Firm Size and Return on Equity as the Controlling Variables in Listed Consumer Goods Industry Companies in Indonesia Stock Exchange"**

1.2 Problem Limitation

This research does not discuss every factor that gives impact on dividend policy. This research focuses only on the impact of earning management on dividend policy, while firm size and return on equity act as the control variables. Besides, this research will focus only on Consumer Goods Industry as one of the industries that averagely able to pay a constant dividend for 8 years in a row. The period of the study is limited from 2011 to 2018.

1.3 Problem Formulation

Referring to the background of problems stated above, the following problems can be identified:

1. Does earning management have impact on dividend policy in consumer goods companies listed in Indonesia Stock Exchange?
2. Does earning management have impact on dividend policy with firm size and return on equity as the controlling variables in consumer goods companies listed in Indonesia Stock Exchange?

1.4 Objectives of the Research

Referring to the background of problems stated above, the following problems can be identified:

1. Does earning management have impact on dividend policy in consumer goods companies listed in Indonesia Stock Exchange?
2. Does earning management have impact on dividend policy with firm size and return on equity as the controlling variables in consumer goods companies listed in Indonesia Stock Exchange?

1.5 Benefits of the Research

This study is expected to be advantageous both theoretically and practically as elaborated below:

1.5.1 Theoretical Benefit

1. For Writer

   This study is expected to give the writer a better understanding regarding the impact of earning management on dividend policy with firm size and return on equity as the controlling variables.

2. For Academicians

   This study is expected to provide deeper information and contribute to the development of science knowledge especially in the area of financial accounting and behavior management, especially in the field of earnings. Other than that, this research also can be used as a reference and comparison with previous research related to factors affect dividend policy.

1.5.2 Practical Benefit

1. For Firms:

   This study is expected to give broader image regarding earnings behavior and dividend policy which will lead the firm to have better decision making.

2. For Financial Statement Users:

   This study is expected to provide information regarding the role of earning management on dividend policy, which will help the stakeholders in making decisions. Moreover, this will also help the investors to make better investing decisions.

1.6 Systems of Writing

To provide a comprehensive picture of the contents of this study, the paper is divided into five chapters as follows:

CHAPTER I: Introduction

This chapter describes the background of the study. From this background, the problem is formulated, followed by the objectives and the benefits from this study, as well as the system of writing.

CHAPTER II: Literature Review and Hypothesis Development

This chapter consists of the foundation of the study which is the theories that will support the formulation of hypotheses. Analysis results of research, previous research, hypothesis development, research model and the framework of thinking.

CHAPTER III: Research Methodology

This chapter describes the methodology of the research. Starting from the population and the sample, followed by the definition of each variable used in the research, method used to collect the data and the data analysis.

CHAPTER IV: Data Analysis and Discussion

Chapter Four describes Research findings which consist of the data classification, data analysis, descriptive statistic, the result of data quality testing, the result of hypothesis testing and the discussion.

CHAPTER V: Conclusion

This chapter consists of Conclusion, Implication and Recommendation.