CHAPTER I

INTRODUCTION

1.1 Research Background

A company in general will try to compete in order to survive and thrive in the world market. A company must be able to has its own excellence over other companies. In addition, a company must be able to offer quality products for the community. One of the performance appraisals of a company is from financial reports, which means that the company must manage its financial statements by ensuring the sustainability of the company. One of the important components of the financial report that the parties concerned assessed is the amount of earning generated by company, which is shown in the income statement.

Generally, earnings information is an important factor in measuring management performance, besides that the earnings information helps owners and other parties with an interest in the company conduct an assessment earning power of the company in the future. So, in order to make good information for the investors about company's net income, the management often doing earnings management (Nufus, 2009).

Earnings management is generally based on various good reasons to satisfy the interests of the owner of the compny such as increasing the value of the company so that it will appear that the company has good prospects for investment because the company has low risk, increases the company's stock price, and the opportunistic behavior of managers such as to obtain compensation, and maintain their positions (Juniarti and

Corolina, 2005). However, with the existence of earnings management, according to Kim et.al (2012) all companies in various sizes are proven to always report positive earnings, to avoid earnings losses or earning decreases. The manager's behavior in time tends to have an impact on manipulation practices (Handayani and Rachadi , 2009).

Various cases of earnings management practices have been found at this time, for example, PT. Indofarma (Persero) Tbk, which the evidence has been founded that net income is considered to be higher than it should be because the work in process account is considered larger than it should be. Then for the case of PT Kimia Farma, where there was an error in the company's net profit assessment of 132 billions rupiah (Sudirman, 2018). Then there are still more companies in the property sector that are proven to experience earnings management practices such as PT Bakrieland development Tbk, PT Metropolitas Kentjana Tbk, PT Pudjiadi Prestige Limited Tbk

Earnings management appears as an impact of agency problems where there is a misalignment of interests between owners and management (Beneish, 2001). One mechanism used to try to reduce conflicts caused by the separation of ownership and control between the two parties is by offering managers to participate in stock option programs known as stock-based compensation. Providing compensation to managers will result in an increase in managerial ownership (Prempanichnukul and Krittaya, 2012).

Information in a company is very important, so it is needed by the owner or principal. Therefore, the management or agent must convey this information in a transparent manner. However, it often happens that the management (agent) in conveying information to the principal is not in accordance with the circumstances. This is done by the agent because the principal gives the agent the authority and authority to run the company for the benefit of the principal. This is because the manager as agent knows more accurate information about the company rather than the principal (Rahmawati, et al. 2006). The manager assumes that if he improves his performance by taking this action, the principal will give a bonus to the agent. Extensive information regarding the condition of the company owned by the agent and minimal information received by the principal is called information asymmetry, so that it provides an opportunity for agents to take earnings management practices.

Information asymmetry is a condition where managers have access to information on the company's prospects but not owned by other parties outside companies. Jensen and Meckling (1976) said that if both parties (principal and agent) are seeking in maximize utility, then the assumption of the agent will not always act in the best interest of the principal can be considered. Principals can limit by setting the right incentives for agents and do monitor that is designed to limit the aberrant activites of the agent (Lasdi, 2013).

Research conducted by Lasdi (2013) and Dadbeh and Mogharebi (2013) states that there is a positive relationship between information asymmetry and earnings management. So, when information asymmetry is high, stakeholders do not have sufficient resources, incentives or access to relevant information to monitor management actions. This will provide opportunities for managers to manage earnings. Although another research has a different result, it is by Azhar and Islahuddin. (2018), that stated partially, operating cash flow and external audit quality affected earnings management whereas audit committee size and information asymmetry did not affect earnings management.

Earnings management arises as an impact of agency problems where there is a misalignment of interests between owners and management (Beneish, 2001). According to agency theory, conflicts of interest occur when both parties (owners and managers) want to maximize their own wealth, thereby causing agency problems (Jensen and Meckling, 1976). One of the mechanisms used to try to reduce conflicts caused by the separation of ownership and control between the two parties is by offering managers to participate in stock option programs known as stock-based compensation. Providing this compensation to managers will result in an increase in managerial ownership (Prempanichnukul and Krittaya, 2012). Theoretically, management who has a high percentage of share ownership will act like someone who holds an interest in the company. This assumption is in line with the contracting-based theory which shows that management will be efficient in choosing accounting methods that will provide added value to the company (Christie and Zimmerman, 1994).

Managers who hold company shares will be reviewed by the parties involved in the contract such as the selection of the audit committee which creates a demand for quality financial reporting by shareholders, creditors, and users of financial reports to ensure the efficiency of the contracts made. Thus, management will be motivated to prepare quality financial reports. This will reflect better contract conditions (Ball et al., 2000, 2003).

Share ownership that owned by managers is one of method to reduce agency cost, where managerial ownership could align a managers and owner interests. Managerial ownership is a percentage of shares ownership by manager. The research supports the evidence that managerial ownership reduces the opportunistic drive of managers and thus reduces earnings management. The ownership of a manager will determine the policies and decisions on the accounting methods applied to the companies they manage. Therefore, it can be said that a certain percentage of share ownership by management tends to influence earnings management practice.

Therefore, it is possible that the level of managerial ownership will be in the same direction to suppress management's use of discretionary accruals (earnings management). In addition to managerial ownership as a monitoring mechanism aimed at aligning various interests in the company, institutional ownership is also thought to be able to provide a similar oversight mechanism in company. Research conducted by Mahariana and Ramantha (2014) shows that managerial ownership has a negative effect on earnings management.

Another research done by Fitriyani et al. (2018) stated that managerial ownership can reduce earnings management. This result was contrary with another research done by Yang et al. (2008) that stated managerial ownership have positive effect on earnings management.

Evodila et al. (2020) concluded that information asymmetry and managerial ownership have a significant effect on earnings management, while financial performance and financial leverage do not have a significant effect on earnings management. The results of this study also indicate that the audit committee is able to moderate the effect of information asymmetry on earnings management, on the other hand, the audit committee is unable to moderate financial performance and financial leverage on earnings management.

The inconsistency of the research results shown by previous researchers, and the number of cases regarding earnings management, encourages the author to choose a topic regarding the effect of information asymmetry and managerial ownership on earnings management. The object of this research are manufacturing companies that listed on Indonesia Stock Exchange period 2014-2018, where manufacturing companies listed on Indonesia Stock Exchange are included in the basic and chemical industry sectors, various industries and the consumer goods industry.

Based on the research background above, this research entitled: **THE EFFECT OF INFORMATION ASYMMETRY AND MANAGERIAL OWNERSHIP ON EARNINGS MANAGEMENT.**

1.2 Research Problems

Based on the research background, so the research questions as follows:

1. Does information asymmetry have effect on earnings management?
2. Does managerial ownership have effect on earnings management?

1.3 Research Purposes

The research purposes are to provide the empirical evidence regarding:

1. The effect of information asymmetry on earnings management.
2. The effect of managerial ownership on earnings management.

1.4 Research Benefit

1. **Practical Benefit**

   This research can contribute and provide especially information for the management to be taken into consideration in determining company policy that can minimize earnings management practices.

2. **Theoretical Benefit**

   Researchers try to provide empirical evidence regarding the information asymmetry of the effect of firm size, and managerial ownership, on earnings management and this research can be referenced for further research with the same topics.

1.5 Research Scopes

Research scopes are the variables affecting earnings management thar are: information asymmetry, firm size, managerial ownership. Another scopes is manufacturing companies that listed in IDX on period 2015-2019 for samples.

1.6 Systematic Discussion

To make it easier for readers to understand the contents of this thesis, it is arranged systematically as follows:

CHAPTER I **INTRODUCTION**

This chapter explains why this research needs to be done, and what makes this research different from previous research. This chapter contains background problems, research problem, research objectives, research benefits, and systematic discussion.

CHAPTER II **LITERATURE REVIEW**

Includes: theoretical basis, review of previous research, framework of thought, and hypotheses.

CHAPTER III **RESEARCH METHODOLOGY**

This chapter contains research variables and their definitions, population and sample determination, types and sources of data, data collection methods, and data analysis used.

CHAPTER IV **RESULTS AND DISCUSSION**

Includes: discussion of research results, data analysis, and a complete explanation.

CHAPTER V **CONCLUSIONS AND RECOMENDATIONS**

This chapter is the closing part of this thesis, which presents conclusions and suggestions that are relevant to the results of the research that has been done.