CHAPTER 1

INTRODUCTION

1.1 Background of the Study

One of the key elements that can be used to estimate company performance is its financial statements. And among the information contained in financial statements earnings represent the most important accounting information. According to PSAK No. 1, earnings information is necessary to assess potential changes in economic resources that might be controllable in the future, to generate cash flow from existing resources, and for formulating considerations about the effectiveness of a company in utilizing its additional resources. In addition, the importance of earnings information has been expressed clearly in the Statement of Financial Accounting Concept(SFAC) No. 1 that besides assessing management performance, earnings also help in estimating representative earnings ability, and estimating risks in investments or credits

Hence, it is inevitable that one of the most important components in financial statements is none other than the earnings. Earnings numbers give extensive insights starting from company performance to its ability to pay a dividend which is influential enough to impact the outcome of investment decisions. Moreover, earnings information act as a form of responsibility from the management of a company to its shareholders. This raises the need for a company to possess sustainable growing earnings to reflect good future profitability deemed favorable to attract investors and maintain shareholders. Given the importance of earnings information, oftentimes it motivates managers to pursue every possible way trying to prepare financial statements that are appealing in the eyes of both internal and external parties.

Therefore, it is unfortunate that despite their attractiveness, appealing earnings do not necessarily ensure the quality of the earnings. Because as was mentioned above, managements are capable of using various practices to provide appealing earnings. In which, the majority of them bring about the outcome of reducing the quality of information presented in financial statements. This is likely to happen because the management as the one who prepares financial statements has the upper hand, where they have access to more information about the company's condition compared to the investor as the external party who is not involved in company activity. This information asymmetry creates the opportunity for a manager to perform earnings manipulation that resulted in poor quality of earnings.

Issues of accounting information quality, with particular emphasis on earnings quality, have received much attention in the financial and accounting literature in both developed and developing countries for many years. Especially after the infamous high-profile financial scandals involving countries from different parts of the world (Enron, Worldcom, and Parmalat). These trigger the interest of investors along with other financial statement users towards the importance of earnings quality. According to Francis (2006), good earnings quality is earnings information that precisely reflects the real condition of a company and contains less uncertainty.

Quality of earnings is very important for users of financial information. In particular, for investors, analysts, and policymakers who require credible accounting information to assess the real economic performance of a firm and to take subsequently optimal decisions. And earnings are the primary information source for investors rather than any other performance indicators such as dividends and cash flows (Menicucci, 2020). Low earnings quality is unfavorable because it may mislead users, and causing misplacement of resources, inefficient allocation of resources and as a result cause inappropriate transfer of wealth.

One way to increase the quality of earnings is by limiting the opportunity to conduct earning management. In which accounting conservatism appears to be the ideal principle used in overcoming the problem. Conservatism holds that when you are in doubt, it is best to choose the accounting alternative that will be least likely to overstate assets or income. The result from previous studies shows that applying conservatism results in a lower earnings management level. As mention by Watts (2003), LaFond and Watts (2008), and Haniati and Fitriany (2010) conservatism reduces the manipulation practices by management as it limits the manager’s opportunity to overstate assets and earnings numbers. Besides that, Lara (2009) states that companies with good corporate governance use accounting conservatism to protect investors by providing information about bad news at the right time.

Another way to address this problem is to first address the conflict of interests between the agent and the principal to generate high quality of earnings. As stated by Jensen and Meckling (1976), ownership structure - managerial ownership and institutional ownership –are mechanisms that can help control agency problems. In reality, the management's sensitivity towards the influence of shareholders depends on the level of managerial ownership. Therefore, the agency problem is assumed to be minimized and the quality of reported earnings can be influenced when a manager is also an owner at the same time.

The table below shows the conditions of several companies during the period 2016-2019. The calculation of quality of earnings is done by measuring the quality of income ratio as one of the proxies. A higher ratio indicates a higher quality of earnings, while a lower ratio of quality of income ratio indicates a lower quality of earnings. It can be seen on Chitose International, Ultraja Milk Industry & Trading Co., Wismilak Inti Makmur in the table below.

Table 1.1 Managerial Ownership, Accounting Conservatism, Institutional Ownership and Quality of Earnings During 2017-2019

Company	Year	Quality of Earnings	Info	Accounting Conservatism	Info	Managerial Ownership	Institutional Ownership
Chitose International	2016	1,928347032	**Higher**	0,024890945	**Higher**	0,30 %	68,43 %
	2017	1,120484411	**Higher**	-0,013535829	**Lower**	0,27 %	66,62 %
	2018	-0,721143163	**Lower**	-0,069213716	**Lower**	0,27 %	70,67 %
	2019	0,270825803	**Higher**	-0,032706737	**Lower**	0,27 %	77,56 %
Ultrajaya Milk Industry & Trading Co.	2016	1,09760561	**Higher**	-0,005374000	**Lower**	11,49 %	15,70 %
	2017	1,492919006	**Higher**	0,010865545	**Higher**	33,85 %	15,46 %
	2018	0,820720147	**Higher**	-0,013402765	**Lower**	34,35 %	14,90 %
	2019	1,058841644	**Higher**	-0,004197637	**Lower**	36,02 %	14,98 %
Wismilak Inti Makmur	2016	1,286140415	**Higher**	-0,015275278	**Lower**	24,80 %	27,62 %
	2017	4,794264325	**Higher**	0,083523037	**Higher**	38,00 %	5,14 %
	2018	2,756546731	**Higher**	0,026980544	**Higher**	38,02 %	5,52 %
	2019	7,291029131	**Higher**	0,085001442	**Higher**	38,02 %	5,10 %

Source: Prepared by the Writer (2021)

As shown in the table above, inconsistencies are present in the relationship of the variables. In several cases, the low quality of earnings persists despite the presence of managerial ownership and accounting conservatism. In the other case, in the absence of the influence of accounting conservatism and the moderating effect of institutional ownership company may still yield high quality earnings. For instance: the cases happened on Chitose International, Ultraja Milk Industry & Trading Co., and Wismilak Inti Makmur.

The cases shown on phenomenon table above reflects both of the two conflicting theories on reducing conflict of interest between managers and shareholder. Which are the managerial entrenchment hypothesis and interest alignment hypothesis. According to the managerial entrenchment hypothesis, managers have so much power that they have the opportunity to utilize the firm to further their interests rather than the interests of shareholders in the accounting reporting context (Niu, 2006). Therefore, with the existence of managerial ownership monitoring will be more difficult.

On the other hand, according to the interest alignment hypothesis, managers' motivation to perform well will effectively increase in the presence of stock ownership by either Board of Commissioners or management. Jensen and Meckling (1976) argued that managers with lower ownership have a higher possibility to manipulate financial statements to eliminate barriers imposed on compensation contracts based on accounting. Meanwhile, the Board of Commissioners with a smaller share of ownership are not monitoring the managers effectively. Many companies are asking their commissioners to increase their stock ownership (Hambrick & Jackson, 2000).

A closely related issue of managerial ownership is institutional ownership. In this case, there is a debate about different outcomes that institutional ownership will bring about depending on the period of holding the shares. Generally, it is presumed that the managers' tendency to manage reported earnings may be reduced by the effectiveness of external monitoring by institutional investors. However, it is inseparable from the possibility that institutional investors may lead managers to conduct accounting decisions that improve short-term profits at the expense of long-term value. Because there are cases where institutional investors are just temporary owners that focus more on current profit. Hence, this research treats Institutional Ownership as a moderating variable.

This is one of the reason for the writer to find out about the influence that managerial ownership and accounting conservatism gives to the quality of earnings with the moderating effect of institutional ownership. From an investment perspective, low quality of earnings is undesirable because oftentimes it raises a false signal leading to misallocation of capital and inefficiently reduce the economic growth. To some extent, low quality of earnings can be considered fraudulent because they divert resources from substantive projects with actually expected payoffs to chimerical projects with imaginary expected payoffs.

In general, shareholders, creditors, standard setters, capital market rely on earnings as an output of financial statements. More often than not, earnings are used as a benchmark in resource allocations, compensation arrangements, investment decisions, and also in measuring performance. Thus, low quality of earnings is very unfavorable for many parties. Constructing decisions based on unreliable earnings figures will result in problematic situations such as unintended transfer of wealth, overcompensation to managers, faulty lending to a deteriorating firm, and defer foreclosure.

A company's quality of earnings may be influenced by several factors, which are accounting conservatism, ownership structure, board characteristics, audit committee. This matter has been researched by many researchers, where accounting conservatism and ownership structure are two of the factors.

Several kinds of research related to the quality of earnings have been done. And between them, a lot of research related to earnings quality is focused on developed countries. Hence this research will focus on Indonesia as an emerging country. In the previous researches, the presence of inconsistencies is still evident in the findings that further research is needed to fill in the research gaps. Thus, this research paper will discuss "**The Influence of Managerial Ownership and Accounting Conservatism On Quality of Earnings with the Institutional Ownership as moderating variable in Consumer Goods Companies Listed in Indonesia Stock Exchange**".

1.2 Problem Limitation

This research does not discuss every factor that gives an influence on the quality of earnings. This research focuses only on the influence of managerial ownership and accounting conservatism on the quality of earnings, while institutional ownership acts as the moderating variable. Besides, this research will focus only on Consumer Goods Industry. The period of the study is limited from 2016 to 2019.

1.3 Problem Formulation

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

1. Does managerial ownership give a significant influence on the quality of earnings in consumer goods companies listed on the Indonesia Stock Exchange?
2. Does accounting conservatism give a significant influence on the quality of earnings in consumer goods companies listed on the Indonesia Stock Exchange?
3. Do managerial ownership and accounting conservatism give a significant influence on the quality of earnings in consumer goods companies listed on the Indonesia Stock Exchange simultaneously?
4. Does institutional ownership give moderating effect to the significance of influence managerial ownership has on the quality of earnings in consumer goods companies listed in the Indonesia Stock Exchange?

5. Does institutional ownership give moderating effect to the significance of influence accounting conservatism has on the quality of earnings in consumer goods companies listed on the Indonesia Stock Exchange?
6. Does institutional ownership give moderating effect on the influence of managerial ownership and accounting conservatism on the quality of earnings in consumer goods companies listed on the Indonesia Stock Exchange?

1.4 Objectives of the Research

Referring to the problem formulation stated above, the objectives expected from this research are as follows:

1. To understand the significance of the influence managerial ownership gives to the quality of earnings in consumer goods companies listed in Indonesia Stock Exchange partially.
2. To understand the significance of the influence that accounting conservatism gives to the quality of earnings in consumer goods companies listed on the Indonesia Stock Exchange partially.
3. To understand the significance of the influence that managerial ownership and accounting conservatism give to the quality of earnings in consumer goods companies listed on the Indonesia Stock Exchange simultaneously.
4. To understand the moderating effect institutional ownership gives to the significance of influence managerial ownership has on the quality of

earnings in consumer goods companies listed in Indonesia Stock Exchange partially.

5. To understand the moderating effect institutional ownership gives to the significance of influence accounting conservatism has on the quality of earnings in consumer goods companies listed in Indonesia Stock Exchange partially.

6. To understand the moderating effect that institutional ownership gives to the significance of influence managerial ownership and accounting conservatism have on the quality of earnings in consumer goods companies listed in Indonesia Stock Exchange simultaneously.

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 of the impact of managerial ownership and accounting conservatism on the quality of earnings with institutional ownership as the moderating variable.

2. For Academicians

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

1.5.2 Practical Benefit

1. For Firms :

   This study is expected to give a broader image regarding the quality of earnings, managerial ownership, and accounting conservatism 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 managerial ownership and accounting conservatism on the quality of earnings, which will help the stakeholders in making decisions. Moreover, this will also help the users to make better decisions.