CHAPTER I

INTRODUCTION

1.1 Research Background

The importance of accurate and reliable financial statements cannot be underestimated for all businesses and their related parties. Financial statements play an immense role as a source of information to assess the performance of a company (Nurdiniah & Herlina, 2015). The Indonesian Institute of Accountants (IAI) defines financial statements as the products of the accounting process that intend to generate information about the financial position and performance of companies which will benefit and assist the users in making economic decisions and demonstrate the accountability as well as stewardship of the management of a company in terms of using the company's resources.

The information provided in the financial statements will be used by both external and internal parties affected by a business (Nugroho, 2015). It serves various needs and interests of an entity's stakeholders such as for making investment decisions, constructing strategies, analyzing company's solvency, assessing company's potential for success, or estimating failures. This information is prepared and presented to the interested parties in accordance to the financial accounting standards and applicable financial reporting framework through various forms of financial statements including the balance sheet, income statement,

statement of changes in equity, cash flow statement, and notes to the financial statements.

Ideally, financial statements should serve as a primary and reliable means or media for communicating the overall state of a business entity to its stakeholders. Moreover, according to Pujiati and Arfan (2013), financial statements can also be used by the managers of a company as a tool to demonstrate their achievements of objectives as well as their compliance to their functions and responsibilities in running a business entity. Therefore, In order to properly deliver of their functions, roles, and objectives, the financial statements should be free of any kind of manipulation and groundless adjustments.

One of the information in the financial statements that is of concern to the stakeholders of a company is the information on profits or earnings. Profits or earnings can be defined as an excess amount of revenue after the deduction of costs within a certain period of business operation. Earnings information is able to reflect the overall performance of the management of a business entity (Pujiati & Arfan, 2013). The Statement of Financial Accounting Concepts (SFAC) No. 1 stated that earnings information, as a means of measurement of management's performance, is the key focus for assessing managers' stewardship and accountability (FASB, 1978). Furthermore, earnings information is also useful for the user of the financial statements to estimate the entity's earnings power and long-term performance (Manuhutu & Setyadi, 2016).

However, the ideal goals and functions of earnings information and financial statements as a whole would not be attained when there lies an agency problem between the shareholders as the principals, and the management as the agent of a company. Jensen and Meckling (1976) stated that in a case where both principal and agents are utility maximizer, it is fair to expect that the agent will not always act in the best interest of the principals. In an agency relationship, the management runs the company on behalf of the principals. This tends to trigger a conflict of interest between the two parties. As the management has been delegated a decision-making authority by the principals, and possesses more knowledge about the company, the management could take any necessary actions to achieve a targeted performance or earnings figure to maximize his/ her own utility.

The importance of earnings figure in the financial statements may trigger a defective response from the managers. Ferdiansyah (2014) stated that the function of earnings information as a performance assessment may result in deviant behavior from the management. According to Saftiana, Mukhtaruddin, Putri, and Ferina (2017), management always tries to show good performance on the financial statements, especially on the earnings figure. Thus, managers may apply certain modifications on the prepared financial statements in order to achieve the desired amount of profit. Such conduct of disclosing company's earnings in a way that is more beneficial and suitable to the company is known as the earnings management.

Earnings management can be described as the choice of accounting policies made by the management to achieve certain objectives (Scott, 2009). There are various motivations for managers to manage earnings. Watts and Zimmerman

(1986) in the positive accounting theory explained three factors affecting the way the management choose the accounting standards and methods in reporting the company's earnings. These factors include bonus plan, debt covenants, and political costs. Bonus plan represents the incentives that managers will receive for the achievement of performance targets. Managers tend to be motivated to perform earnings management when there is an arrangement of bonuses included as part of the compensation for the achievement of targeted earnings. Debt covenants, as measured by company's leverage, will motivate managers to manage earnings as they will avoid breaching the leverage ratio constraint in the covenant. This leads them to choose the income-increasing accounting method. Lastly, the size of a company will determine the amount of political cost to be incurred and thus, motivate the managers to select accounting methods that will reduce such costs.

The conduct of managers to choose accounting methods or techniques to produce financial reports that presents the desired state of company's performance is facilitated by accounting's accrual basis (Wiyadi, Trisnawati, Sasongko, & Fauzi, 2015). This way of managing earnings is known as the accrual earnings management. However, for some reasons and limitations, some managers might shift to managing company's earnings through real activities which is called the real earnings management. Roychowdhury (2006) described real earnings management as an act of managers that deviates from the normal business practice with the purpose of achieving an intended earnings result. Both ways of managing earnings are perceived as being manipulative which will harm the credibility of the financial statements as an important means of communication between the management and the external parties.

This research is a development on the research of Nurdiniah and Herlina (2015) that analyzed the influence of bonus plan, debt covenant, and political costs as motivational factors towards the practice of earnings management. The discussion of those researches, however, were limited only to the accrual-based earnings management. Based on the stated research background, the researcher is motivated to analyze the three factors of bonus plan, debt covenants, and political cost from the positive accounting theory in terms of their relationship and effects to the motivation of managers in performing not only the accrual earnings management, but also the real earnings management practices. Therefore, this research is titled, "The Influence of Bonus Plan, Debt Covenant, and Political Cost towards the Motivation for Accrual and Real Earnings Management Practices of manufacturing companies Listed in Indonesia Stock Exchange from 2015 – 2017".

1.2 Problem Statement

The problem in this research is about whether a company's bonus plan, debt covenants, and political costs can be used as measuring instruments to indicate the presence of earnings management activity in the company and the level of motivation of the company's managers to manage earnings. Hence, the issues to be examined in this study are as follows:

1. Does a company's bonus plan affect the motivation for earnings management practices (accrual and real) of manufacturing companies listed in Indonesia Stock Exchange from 2015 – 2017?
2. Does a company's debt covenant affect the motivation for earnings management practices (accrual and real) of manufacturing companies listed in Indonesia Stock Exchange from 2015 – 2017?
3. Does a company's political cost affect the motivation for earnings management practices (accrual and real) of manufacturing companies listed in Indonesia Stock Exchange from 2015 – 2017?

1.3 Research Purpose

The purpose of this research is to test:

1. Whether bonus plan has an influence towards the motivation for earnings management practices (accrual and real) of manufacturing companies listed in the Indonesia Stock Exchange from 2015 – 2017.
2. Whether debt covenant has an influence towards the motivation for earnings management practices (accrual and real) of manufacturing companies listed in the Indonesia Stock Exchange from 2015 – 2017.
3. Whether political cost has an influence towards the motivation for earnings management practices (accrual and real) of manufacturing companies listed in the Indonesia Stock Exchange from 2015 – 2017.

1.4 Research Benefits

The benefits from this research are addressed to:

1. Investors. This research will provide investors a means to obtain knowledge about bonus plan, debt covenant, and political cost that may appear in a company and their relationship to both the accrual and real earnings management practices. This knowledge could assist them in making decisions for a company in which they intend to invest their funds.
2. Company's management. This research will assist the management of a company to identify the possibility of both the accrual and real earnings management practices to occur within the company based on the influencing factors such as bonus plan, debt covenant, and political cost of the company.
3. Lenders. This research provides information that could be useful for lenders or other third parties that are affected by a company's business operation. This research will allow lenders to obtain knowledge about accrual and real management of earnings that may be performed by managers of a company which will affect their decision in approving loans or other forms of financial support to their clients.
4. Researchers. This research will be useful for researchers to gain knowledge about the impact of bonus plan, debt covenant, and political cost towards both the accrual and real earnings management including each of the variables' means of measurement which include the bonus scheme included in sample companies' remuneration package, leverage (Debt-to-Total Asset), and

company size. This research can be used as a reference for other researchers in doing their own research.

1.5 Research Limitations

This research mainly discusses the factors that affect the motivation to perform earnings management (accrual and real). The factors or independent variables included in this study are bonus plan, debt covenant, and political cost. In addition, control variables are also included to this research which are profitability and growth. Among various possible proxies to be used, there will only be one proxy chosen for each independent variable in this research. The bonus plan variable will be proxied directly using the existence of bonus scheme included in sample companies' compensation package, while debt covenant will be measured by using leverage ratio of Debt-to-Total Asset, and political cost will use company size as its proxy. The companies included in this study are only companies that are included in the consumer goods and miscellaneous sectors of manufacturing industry that have been listed in the Indonesian Stock Exchange which financial and annual reports are available for the period of 2015 – 2017.

1.6 Systematic Discussion

This research is comprised of several chapters and subchapters. The structure of the discussion will be presented as following:

Chapter I: Introduction

This chapter discusses the background of the research and provides brief explanation on the topic to be discussed as well as the reason for choosing the topic. This chapter is comprised of several subchapters which include the research background, problem statement, research purpose, research benefits, research limitations, and systematic discussion. This chapter will give the readers an overview of the issues to be discussed in this study.

Chapter II: Theoretical Framework and Hypothesis Development

This chapter provides discussion and explanation on the theories and concepts related to the topic of and problems in the study. Aside from discussion of theories and concepts, this chapter will also provide a development on hypotheses to be tested in this research. The subchapters of this chapter include the definition of concept, literature review, conceptual framework, and hypotheses development.

Chapter III: Research Methodology

This chapter mainly provides information and overview on the methods used in the research. This chapter will provide details on the method used in obtaining the data as the research object, the way the research object is selected, and the technique used in processing and analyzing the research object. The subchapters include population and sample, data collection method, empirical research model, definition of operational variables, and data analysis method.

Chapter IV: Analysis and Discussion

This chapter contains the interpretation and analysis on the results of various processing and testing performed on the collected data. Moreover, this chapter also include discussion on the relation of the research results to the results of previous researches.

Chapter V: Conclusion and Suggestion

This chapter presents the conclusion of the research, which is drawn from the results of data processing and testing, the limitations of the research, and the suggestions for future research.