CHAPTER I

INTRODUCTION

1.1 Background

Over time, the issue regarding the theory of earnings management has been raising concerns among financial market regulators, financial operators, investors and also academic researchers according to one of the former US Security Exchange Commission Chairman circa 2002 as quoted by Uwuigbe et al (2015). The concept of earnings management had been going on and has been receiving much attention due to corporate failures. The trend had enlarged the doubts of stakeholders regarding to the credibility and reliability of the financial report. The importance of a company's earnings is quite big such that it should not be over emphasized. To add, according to Uwuigbe et al (2015), the profession in accounting also has responsibility to protect the company, with keeping in mind that a company's final product of the accounting process is earnings.

To define earnings management as according to Ewert and Wagenhofer (2011), earnings management has two basic forms

- Accounting earnings management, which is accrual based. This type of earnings management aims to impact the recognition, measurement and also disclosures of transactions.
- Real earnings management: conducting or structuring transactions to be reported in the financial statements to impact the reported numbers.

To counter the definitions that has been stated above by Ewert and Wagenhofer (2011), the definition made by Cornett et al (2008) should also be taken into consideration. As defined by Cornett et al (2008) he argues that earning management is a preventive step to avoid in-default (failure) circumstances during a loan agreement, to reduce regulatory costs, and increase regulatory benefits. It is an intentional structuring that incorporates smoothing company income behavior and also any try to change reported income.

As conducted in previous studies by Aini et al (2006), the practice of earnings management through the system of accrual accounting is able to result in an inaccurate and misleading financial report, making it difficult to differentiate from the proper accounting practices.

By definition of Healy and Wahlen (1999) and Roychowdury (2006), in the conducting of earnings management, there is always reason as to why the managers turn to this method. The manipulation of amounts in the financial reports due to operational practices seem to happen from the motivation of the firm's management to misinform shareholders and give them assurance and confidence that the firm has reached targets.

Waweru and Riro (2013) elaborated that financial reports with high quality is more acknowledged by investors and other stakeholders that are final users of the said financial reports. By having high quality financial reports, it gives users more reliable information that is finally later used for decision making. In addition, high quality financial reporting increases the transparency level and helps in executing better contracts. In addition, the International Chamber of Commerce (ICC), which is a company that helps business around the globe to operate internationally and responsibly, states that the efficiency of the market and also investors' confidence level increase in the situation where the financial report information is reliable and has high quality in the aspects of consistency, comparability and understandability.

In a journal article by Nugroho and Eko (2011), they argued that the independence of the board of commissioners and the existence of an audit committee contribute to a firm's corporate governance. They also added that those two factors are the main focus for the Indonesia's SEC (Stock Exchange Committee) and regulator, BAPEPAM, (Indonesian Capital Market and Financial Institution Supervisory Agency). Nugroho and Eko (2011) also stated in their research that in addition to independence of board of commissioners and also the existence of audit committee, stock ownership, chief executive officer duality, board size, board composition, board tenure, and board interlock can have effect on a firm's earnings management.

This topic of research is interesting to be researched on because of the fact that this concept of earning management up till now has been topic of debate and concern for regulators, financial operators, investors and researchers. Particularly, this topic of research has been discussed several times in journal articles from other countries outside of Indonesia. With this topic being discussed in many countries, it seemed to be a good opportunity to apply and further explore this research topic into Indonesia.

This research paper will explore deeper about the impact of a firm's characteristics and board characteristics towards earnings management in

Indonesia. This research is made based on companies in Indonesia that is listed on the Indonesia Stock Exchange, with observation years spanning from 2013 to 2017.

Based from the facts above, writer wishes to further study and explore whether firm characteristics such as; firm size, leverage, and corporate strategy impacts the earning management of a company. To conclude, the writer came up with the title of **"THE IMPACT OF FIRM AND BOARD CHARACTERISTICS TOWARDS EARNINGS MANAGEMENT."**

1.2 Research Problem

Based from the background presented above, to achieve the expected target, the researched defines the research problem as follows:

1. Does firm leverage have any influence on the earnings management?
2. Does firm size have any influence on the earnings?
3. Does firm's audit quality have any influence on earnings management?
4. Does independence of Board of Directors have any influence on earnings management?
5. Does CEO duality have any influence on earnings management?
6. Does board size have any influence on earnings management?
7. Does stock ownership have any influence on earnings management?
8. Does board composition have any influence on earnings management?
9. Does the size of an audit committee have any influence on earnings management?

1.3 Research Objectives

The research objective of this study is:

1. To prove empirically that firm leverage does have an effect on earnings management.
2. To prove empirically that firm size has an effect on earnings management.
3. To prove empirically that firm’s audit quality has influence on earnings management.
4. To prove empirically that independence of BOD has influence on earnings management.
5. To prove empirically that CEO duality has influence on earnings management.
6. To prove empirically that board size has influence on earnings management.
7. To prove empirically that stock ownership has influence on earnings management.
8. To prove empirically that board composition has influence on earnings management.
9. To prove empirically that the size of audit committee has influence on earnings management.

1.4 Significance of Study

1. For corporation – to understand better about the effects of one’s leverage in having any effect towards their own real earnings management.

2. For next researcher – to provide additional knowledge regarding any effects or non-effects that is to be discovered through this research.
3. For UPH – This research may also be as help to give more understanding about how theories learned in lectures are applied in the actual world. This research may also be a contribution to the literature collection of the campus library.

1.5 Scope of the Study

For the purpose of this research, it will examine more than 1 independent variable, which is firm characteristics and board characteristics. The financial information gathered will come from public companies that has been listed on the Indonesia Stock Exchange. This research will also limit the observation years to only 5 working company years; 2013, 2014, 2015, 2016, 2017.

1.6 Systematic Discussion

For the purpose of this research, this paper is systematically divided into five chapters as follows.

CHAPTER 1 INTRODUCTION

This chapter will converse subchapters such as the background of the research, research problem, research objectives, significance of study, scope of study, and lastly about the systematic discussion.

CHAPTER 2 THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

This chapter will discuss theories regarding the topic being explored. This will include the definitions, explanations, and hypothesis development.

CHAPTER 3 RESEARCH METHODOLOGY

This chapter will give discussion regarding what method of research has been done to the data. This chapter will cover population and sample, measurement model, empirical model, and method for data collection and analysis.

CHAPTER 4 RESULTS AND DISCUSSION

This chapter will cover the results and the empirical findings of the data that has been processed in relation to the real earnings management.

CHAPTER 5 CONCLUSION AND RECOMMENDATION

This chapter will conclude the research and will include a short summary to cover again all the main points of the findings as well as suggestions that may arise from the subsequent findings of the research.