CHAPTER I

INTRODUCTION

1.1 Background of the Study

In the current era, more investors intend to invest their capital in companies. Investors are people that inject their money into the company for a certain time to achieve profit in return by exchanging their money with the ownership of the company they are going to invest. Investors invest their capital with the aim of obtaining a return from the company. They certainly invest their capital in companies that sell shares to the public that are listed at the capital market. Investors, before investing, certainly look at the company's financial condition, especially looking at the condition of profits and operational activities. If the company has a good financial condition, they will definitely be more enthusiastic and ready to inject their capital, and vice versa.

The capital market is a place where investors are connected with companies. All companies that go public will be listed on the capital market. The capital market helps the country's economy by helping the expansion of company-owned businesses. The capital market helps companies to raise funds and provides returns for investors who have invested in companies. The capital market assists the country's economy by helping companies with allocating funds to companies that are experiencing financial problems or a lack of capital, so that the company can continue to carry out its operational activities. The capital market provides all forms of information about the company and monitors how the company is doing so that the financial report is more trusted by the public.

The capital market has the role of monitoring all activities carried out by companies, as well as providing important information and implementing mechanisms that maintain relationships between investors and companies, including ensuring reliable data. The purpose of providing reliable data is to provide investors with an overview of the performance of the company and how the company's operational activities actually are. Investors need to understand the condition of the company and explore more deeply about the company's past and current financial condition, along with the company's history, so that all transactions made into the company are safer.

Investors can analyze various existing sectors and how the company is performing financially and non-financially. Generally, investors will pay attention to financial conditions because good financial conditions show good performance of the company management and good internal control. The financial condition of the company could be seen and analyzed through financial reports that are reported for the use of the public.

Financial statements must be reported in a structured, clear and understandable manner so that investors can be easier to understand the information conveyed in the financial statement. Anthony and Rees (2001) stated that financial reports provide various financial conditions of information in the past that could be used by users as a basis for making decisions, and forecasting for future financial conditions and asset movements within the company.

Financial statements are provided for the purpose of evaluating the company's performance so as to provide significant results in Osadchy et al. (2018). Investors need to be more careful in understanding the financial situation and management of the company, whether they achieve the target and the company's vision and mission or not, with the aim that investors can get the desired return and reduce the risk of losing their capital in the future.

Investors, as external parties, use financial information to assess management ability generating profit. Besides that, they examine management's ability to manage the leverage. On the other hand, management uses financial information to analyze company performance and how to generate profit in order to attract investors' attention. Moreover, by showing higher profit, a company can get good side from the public because it has been successful in carrying out its operational well. Moreover, management can get praise from the public for their hard work and cooperation to develop and prosper shareholders.

Profit is one of the indicators that is being considered by investors because it shows whether companies experience increasing or decreasing result in the current period compared to previous period. Besides that, it shows whether the company is generating a profit or experiencing a loss during a certain period. If the company's management carries out operational activities properly and is able to utilize assets and equity efficiently, it will provide effective results for the company in the form of profit.

Companies with stable profits will provide investors with a greater sense of security than companies with a significant increase in profit. These conditions motivate managers to provide stable profit each year, so that it can impact on the increase in company value in the eyes of investors. If there is a drastic increase or decrease in earnings in a certain period, then investors must be aware and also pay more attention because certain things may happen beyond their imaginable perspective.

Because profit is one of the most researched indicators by investors, as it shows how the company is performing and the level of productivity of the management, so this is often overhauled by management and generally occurs in public listed companies. Management that has a good mechanism can encourage the company's financial condition to be preferable by making appropriate decisions. On the other hand, if the company management does not manage the financial conditions and is not agile at making decisions, it will result in a deteriorating financial situation.

Management is given the discretion to prepare financial reports using various accounting methods and estimates according to their respective needs and company circumstances. However, it must be in accordance with accounting standards and must be relevant and neutral, so it can be used by all parties and provide useful information according to the interests of certain parties as cited in Zakia et al. (2019). Due to this discretion in the preparation of the financial report, it indicates that management affects the financial information contained in the financial statement according to their desires.

Generally, the accrual method of accounting has been applied by companies and is presented in the financial information section of the financial report. Nevertheless, the use of the accrual method relies more on estimates so that the figures presented are not exact numbers, and these can be more easily overhauled and managed by management.

Earnings management is a technique used by managers to beautify, change, or manipulate the financial situation with the aim of providing a positive view for stakeholders in Beneish (2001). Earnings management is not always a bad thing, but most of what has happened is that management tends to misuse the discretion to use accounting policies in the wrong direction, by manipulating existing data and beautifying the financial situation.

Earnings management can be in the form of a bad side or a good side. The good side of earnings management if it is carried out for the benefit of the company and achieves company performance, or it reasonable and proper practice. There is an argument that states the good side of earnings management, namely incentives given on contracts such as bonuses and debt covenant contracts. For example, the volatility of new accounting standards could reduce net income and this is certainly detrimental to managers' effort. Furthermore, the existence of new accounting standards could allow debt covenant violations. Contract violation is quite costly with earnings management, it could reduce the costs. Apart from that, the good side of earning management is investors-based arguments by reporting information about the company to investors with credibility about income expectations in Soon (2011).

The bad side of earnings management is the intervention of management in preparing financial statements and hides information about the operating activities of the company. The bad side of earning management is done by several techniques, such as the contracting perspective and financial reporting perspective. With a contracting perspective, managers manage earnings with the aim of maximizing personal desires. Managers increase earnings in certain periods with the aim of getting more bonuses and job security. With a financial reporting perspective, management reports excessively unusual and non-recurring charges with the aim of increasing earnings in the next period. This would be difficult for investors to diagnose the reasons for the increase in earnings in the subsequent period in Soon (2011).

Earnings management is one of the management interventions with a specific purpose toward the external financial reporting process, deliberately to obtain some personal benefits, as mentioned by Schipper (1989) in Moghaddam and Abbaspour (2017). It makes the users of financial reports not able to get actual financial information because the data submitted is not the actual thing that occurred and does not show the actual condition of the company. Besides that, external parties do not want to see the financial situation on paper, but the actual financial conditions which are obtained from actual operational activities conducted inside the company. This results in the information submitted being biased and therefore cannot be used as a base for making future decisions.

Jensen and Meckling (1976) stated that in an agency relationship between investors (principal) and management (agent) to carry out obligations and are given the authority to work on their behalf, either principal or agent will try to maximize their own interests, so there is a possibility that the agent will not always work for the principal interest and this creates a conflict called agency conflict. Shareholders might lose trust in management because management, as an agent, must prosper shareholders, where shareholders are the owners of the company who give responsibility; but on the contrary, it is detrimental and triggers a conflict.

In addition, many cases of earnings management are still carried out by large companies; moreover, there is a case of an accounting scandal that shocked the world, namely Enron. Enron is one of the largest energy trading companies in the United States and one of the most controversial for accounting scandal. It was first discovered in 2001. The company used various earnings management techniques and violated accounting standards, such as hiding million dollars of bad debts, inflate the earnings, and the mark-to-market method. As a result of these actions, shareholders lost about $74 billion of their capital. Enron's share price fell significantly from $90 to $1 in a year, and more than 20,000 employees lost their jobs and pension benefits. Besides that, the collapse of Enron affects United States financial market because it was the seventh largest corporation in the United States. This action involves the company management and audit firm, Arthur Andersen, which is subject to sanctions in Lemus (2014).

Table 1.1 Data of the Application of Earnings Management, Profitability, Leverage and Sales Growth in Property and Real Estate Companies Listed in Indonesia Stock Exchange for the Year 2018 – 2020

Code	Year	Earnings Management (DACC)	Profitability (ROA) (%)	Leverage (DAR) (%)	Sales Growth (%)
MTLA	2018	-0.082	9.766	33.793	9.122
	2019	-0.083	7.984	36.964	1.806
	2020	-0.130	4.826	31.278	-20.880
PWON	2018	-0.067	11.300	38.798	23.160
	2019	0.017	12.415	30.655	1.714
	2020	-0.012	4.230	33.486	-44.776
RDTX	2018	0.059	10.583	8.433	1.286
	2019	0.048	8.326	9.696	-0.362
	2020	0.103	7.946	7.890	0.333

Source: Prepared by the writer (2021)

Table 1.1 above shows the differences obtained from the calculation results of earning management practice in various companies, followed by some variables that might have an influence on earnings management practices. The companies above are part of property and real estate companies, including PT Metropolitan Land Tbk (MTLA), PT Pakuwon Jati Tbk (PWON), and PT Roda Viviatex Tbk (RDTX).

MTLA showed a significant decrease in leverage (DAR) from 36.964% in 2019 to 31.278% in 2020. In addition, earnings management (DACC) decreased from -0.083 in 2019 to -0.130 in 2020. The decrease in leverage was due to the company paid off certain long-term bank loans portion, which is due to current maturities. However, the decline in DACC was due to monitoring by creditors on the activities of managers. There is a debt covenant that has been determined between creditors and managers, which must be obeyed by the company. Among them are financial ratios, one of which is the debt ratio. To meet certain financial ratios causes managers to focus more on meeting the requirements of these ratios rather than on conducting earnings management practices. The existence of debt makes management activities more monitored by creditors. Besides that, there are limitations in managing the company, so managers do not want to take too much risk. The existence of this monitoring also aims to reduce the risk of creditors due to management actions.

In PWON, profitability decreased drastically from 12.415% in 2019 to 4.230% in 2020. Besides that, DACC also decreased from 0.017 in 2019 to -0.012 in 2020. External conditions caused the company's economy to decline, which affected all business sectors, one of which was property companies. All buying and selling activities were hampered and the business was laid down. As a result of this situation, the company was unable to generate higher income, which resulted in a decreased profitability ratio.

In PWON, besides profitability, sales growth also experienced a drastic decline from 1.714% in 2019 to -44.776% in 2020. This is because sales revenue decreased from Rp7.202.001.193 in 2019 to Rp3.977.211.311 in 2020. The decline in sales was influenced by the decline in people's purchasing power due to the deteriorating economy of the country. Various sectors have been badly affected by the pandemic, but the company is surviving. Thus, the decline in sales did not only occur in this company but also in various companies in this industry. Apart from that, DACC also decreased. This is due to strong monitoring by the audit committee to supervise all activities of the managers. The monitoring by the audit committee is able to control management's actions on financial reporting. In addition, the existence of obligations that must be met by managers causes them to focus more on what they are capable of than what they are not.

Profitability plays an important role in reflecting a company's financial performance. Companies with high level of profitability indicate that the company's performance has been well executed, on the basis of management efforts and could attract the attention of investors. This study uses return on assets, which shows how efficiently the company uses assets and generates returns.

In order to maintain the level of company profitability and obtain more bonuses, managers will be interested in practicing earnings management. This is because the higher company level of profitability shows the better performance of management. Managers will perform earning management practices by increasing reported income by using various accounting methods. Therefore, it is necessary to analyze the effects of profitability on earnings management. Firnanti et al. (2019) stated that profitability indicated by ROA has a significant impact toward earnings management. Controversy with a study by Anindya and Yuyetta (2020) that stated profitability indicated by ROA has an insignificant impact toward earnings management.

Besides profitability, leverage shows how much the company's assets are financed by debt. The higher this ratio indicates, the greater the risk borne by the companies. Generally, large companies use external funds to purchase non-current assets and it can be granted from leveraging. This study uses a debt-to-asset ratio to measure leverage.

The existence of debt covenants with creditors will encourage managers to manage earnings. This can be done when a company approaches debt covenant violations. Managers will use various accounting policies to report the increase in income. Apart from that, strong monitoring by creditors could reduce the ability of managers to conduct earning management practice. The impact of leverage toward earnings management has been analyzed by many researchers. According to Moghaddam and Abbaspour (2017), leverage measured by DAR has a significant impact toward earnings management, but contrasts with a study by Sulaksono (2018) that stated leverage measured by DAR has an insignificant impact toward earnings management.

The last thing is sales growth, the increase in sales from one period to the next period shows that management has performed well in the operational activities. However, if the company experienced a significant decrease in sales from the previous period, it indicates that operational activities were not well directed and directly affected profits in that period. For the purpose to keep sales level, management would like to conduct earnings management practice by managing sales using certain judgments. The aim is to maintain a constant sales from year to year. It is done to attract investors' interest in investing and to give credence to creditors. The result of a study by Firnanti et al. (2019) stated sales growth has a significant impact toward earnings management, but in contrast with study by Abbadi et al. (2016) that show sales growth has an insignificant impact toward earnings management.

Based on the background above, the example provided and the differences between previous research, the writer decided to conduct a research entitled, **"The Impact of Profitability, Leverage and Sales Growth toward Earnings**

Management in Property and Real Estate Companies listed in Indonesia Stock Exchange."

1.2 Problem Limitation

Along with the increasing numbers of earnings management scandals occurring in leading companies, the writer decided to conduct further research related to the factors that have an impact on earnings management practices with the aim to thicken more understanding. There are some of the limitations of this research, such as:

1. Due to time and resources constraint, this research has limited the object of the study, where the objects discussed here are only the Property and Real Estate companies listed in Indonesia Stock Exchange for the year 2018 to 2020.
2. The writer only discussed several variables impact earnings management practices, such as Profitability measured by Return on Asset, Leverage measured by Debt to Asset ratio and Sales Growth.

1.3 Problem Formulation

Based on the background of study stated above, the formulation of the research problem among others, as follows:

1. Does Profitability have a significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange partially?

2. Does Leverage have a significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange partially?
3. Does Sales Growth have a significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange partially?
4. Do Profitability, Leverage and Sales Growth have significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange simultaneously?

1.4 Objective of the Research

This research expects to describe the objectives of this study are as follows:

1. To determine whether Profitability have significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange partially.
2. To determine whether Leverage have significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange partially.
3. To determine whether Sales Growth have significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange partially.

4. To determine whether Profitability, Leverage and Sales Growth have significant impact toward earnings management in property and real estate companies listed in Indonesia Stock Exchange simultaneously.

1.5 Benefit of the Research

The results of this study are expected to provide benefits to several parties, are as follows:

1.5.1 Theoretical Benefit

The writer expects that this research can be used to provide knowledge and beneficial information regarding the impact of profitability, leverage and sales growth on earnings management. The writer also hopes that this research can be used as information to review and reference material for other academics that intend to do further research regarding earnings management.

1.5.2 Practical Benefit

This research is expected to provide practical benefit to some parties, are as follows:

1. For Scholar

   For scholars, it is expected that this research can provide additional information and empirical evidence for other researchers who discuss research on the same topic.

2. For Investors

For investors, the results of this study can be used as additional information regarding the financial condition of the company. Apart from that, they can be more agile in paying attention to the company's financial situation. It can be used as consideration in investment-related decision making.

3. For Companies

For companies, this research can be used as additional information regarding the factors that affect earnings management, as well as prevention of earnings management actions. Apart from that, management can issue financial reports in accordance with accounting standards.