

CHAPTER I

INTRODUCTION

1.1 Background of Study

Financial statements are one of the primary sources used to analyze a company's performance, with earnings as the most essential accounting information (Fridson & Alvarez, 2022). On another note, financial statements also become a major problem as it is regarded as a source of information that can be manipulated in a way that harms the stakeholders involved in the company. With the desire to maximize profit, management has an inclination to engage in earnings management practices (Barus et al., 2019). In which, Gu (2020) observes that earnings management practices have received increasing attention from accounting researchers in the past 20 years. Accordingly, Indonesia is no exception (Fitri & Hakim, 2021).

Indonesia's mining sector has abundant natural resources to attract investors to invest with great potential to be developed. However, the mining sectors are filled with high uncertainty and require huge capital investment with long-term returns (Abdurrahman & Ermawati, 2019; Machmud, 2022). Management of mining companies are, therefore, prone to taken various actions to mitigate unstable commodity prices, depleting mineral reserves, strict environmental restrictions, rising operational costs, and continually fiercer competition (PwC, 2022). This provides an opportunity for management to act according to

their interests by carrying out earnings management to convince investors (Makmur & Semarang, 2021; Gunawan & Kris Resitarini, 2019).

Table 1.1 State Revenue (APBN) Data

Realization of Non-tax State Revenue (PNBN)	APBN Contribution (billion rupiahs)				
	2017	2018	2019	2020	2021
Non-oil and Gas (<i>Non-migas</i>)	28.596	37.798	30.120	28.125	52.822
1. Mineral and coal mining revenues	23.044	30.309	23.739	21.161	44.775
2. Forestry revenues	3.943	4.760	4.488	4.400	5.410
3. Fishery revenues	950	448	460	600	708
4. Geothermal energy revenues	659	2.281	1.433	1.964	1.929

Source: *Kemenkeu.go.id* (2022)

In Table 1.1, data from *Direktorat Jenderal Pengelolaan Pembiayaan dan Risiko Kementerian Keuangan* shows the evident role of mining sector's contribution in supporting Indonesia's economy. Through the revenue generated from mining natural resources, mining companies contributes to the government in the form of Non-Tax State Revenue (PNBP) from the mineral and coal mining subsector, which recorded a record of Rp44.78 trillion at the end of 2021, increasing over 111,7% from prior year. Report from Badan Pusat Statistik (2021) shows that this sector managed to grow 7.78% in year-on-year comparison as the second highest contributors in realizing Indonesia's Q3 2021 economic growth to reach 3.51%.

Regardless, report from World Bank (2018) emphasizes that optimization of earnings in the mining sector is still impeded by low budget transparency and accountability, public investment integrity and implementation in terms of accountability and inclusiveness. Indonesia's mining operations and earnings management reflect the weakest *de jure* performance and the most pronounced *de facto* performance gap. The report (see Fig 1.1) shows insufficient coordination

between stakeholders on a range of issues with artisanal/ illegal mining, responsibilities and duties of company management, etc. The perceived issues with budget execution and public investment management are mostly to account for the *de facto* performance's lower score.

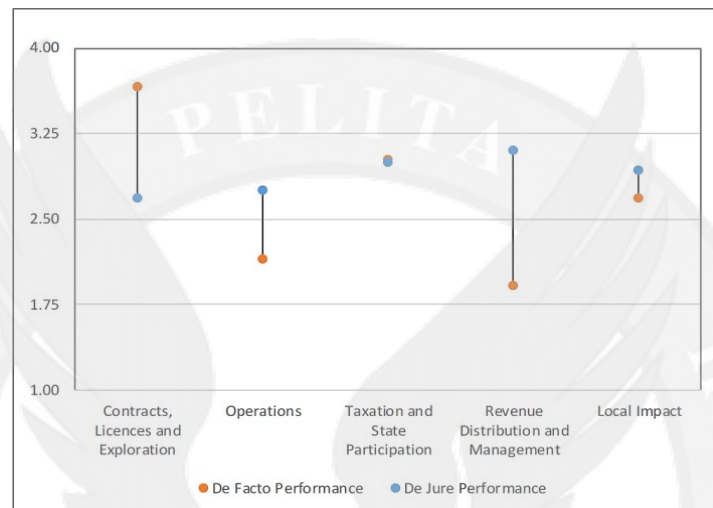


Figure 1.1 Performance Gap on Indonesia Mining Companies

Source: World Bank (2018)

Moreover, according to Public Expenditure and Financial Accountability (PEFA), the mining sector's budgeting expenditures and predictability of in-year revenues allocation are scored poorly. Based on several measures (BTI, Worldwide Governance Indicators, and World Justice Project), financial misrepresentation in the mining sector—revenue management through natural resources funds is common, and not to mention that control is rated as relatively weak. The majority of mining companies are aware of the Illicit Financial Flows (IFFs) in the mining sector which pose a highly negative influence and burden on the sector, in which the miscoordination among company and government levels ease the practice of falsification in earnings management (Indonesia Corruption Watch, 2018).

Earnings management is the practice of management in manipulating financial reporting and structure to deceive stakeholders about the company's financial performance (Davidson et al., 2019). Since financial reports are the main source of information on company's stability, economic activity, and financial health, misleading financial reporting is detrimental to all stakeholders, including the state. This issue has received considerable attention as occurs at an alarming rate in accounting revisions and restatements (Belverd et al., 2018). In Indonesia, this phenomenon is prevalent in large companies as well as state-owned enterprises, as observed by Tsaqif & Agustiningsih (2021), and the mining sector is no exception. The practice of earnings management on the mining sector could, therefore, threaten Indonesia's economic stability.

One of the most prominent cases of earnings management practices was reported on the second largest tin mining company in the world, PT Timah Tbk (TINS), which is a part of Indonesia state-owned enterprise (BUMN) holding. TINS management revised the financial statement for 2018 which was then restated in 2019. As shown on Figure 1.2 below, the actual net profit for PT Timah Tbk was only Rp132.29 billion, but instead the management recorded a misleading net profit of Rp531.35 billion. A significant markup of Rp399.06 billion was added.

This situation arose because company's management failed to record Rp640 billion as cost of goods sold for sales of tin metal. Fixed assets were overreported by Rp25 billion and investment property were underreported by Rp199 billion (Kompas.com, 2020). Finally, TINS financial report as of

December 31, 2019, stated that management reconsidered the interpretation of the relevant facts, circumstances and accounting treatment (IDX, 2022).

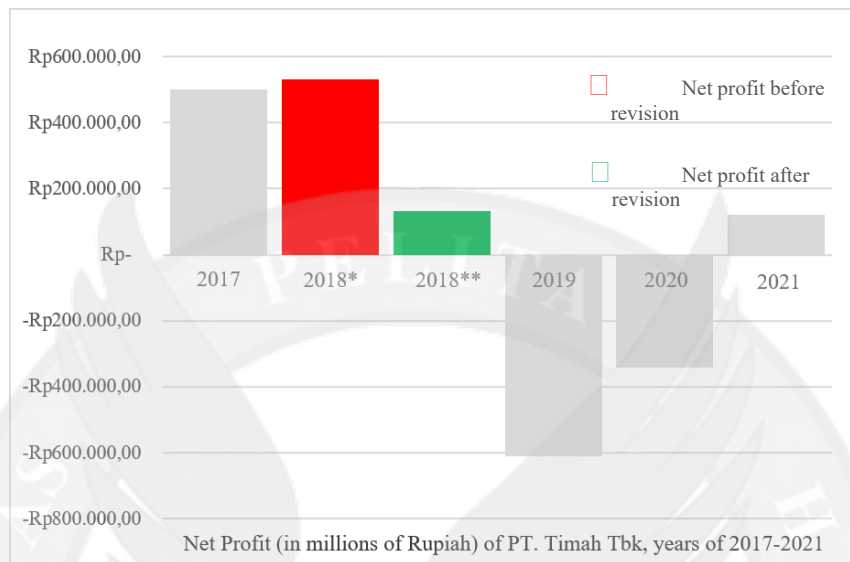


Figure 1.2 Revised 2018 Net Profit of PT. Timah Tbk

Source: Indonesia Stock Exchange (IDX) (2022)

The case of PT. Timah Tbk falls within the category of earnings management models that focus on income maximization. This is a misleading method of recognizing revenue from the sale of real estate, uncollectible prepaid taxes, transactions between businesses belonging to the same group, as well as other issues. When earnings fall, the company's management works to increase sales by inflating the profit reported in the current period's financial statements relative to the actual profit. The objective is to generate profits, receive larger bonuses, and remain within long-term debt agreements (Hutauruk et al., 2022).

Other case of earnings management in the mining sector is also observed at PT Bumi Resources Tbk' when the fluctuation of its share price was inconsistent with its profit earned over an extended time, in which turned out to be a financial diversion. With a pattern of boosting revenue and limiting profits generated by the

management for their own and the company's interests, imbalances may result from earnings management practices (Hutauruk et al., 2022). Additionally, companies like PT Garda Tujuh Buana Tbk, PT Ancora Mining Service, PT Chakra Mineral Tbk, PT Toba Sejahtera, etc. falsify financial accounts in an effort to increase profits through effective earnings management (Kurniawati et al., 2021). These phenomenon of earnings management in Indonesia mining companies are indeed devastating as mining sectors are the backbone of Indonesia economy.

The object of this research is mining sector companies listed on the Indonesia Stock Exchange. With considerable contribution to GDP through its lucrative exports, mining sector in Indonesia plays an important role in the growth of the nation's economy (Li, 2020). According to Badan Pusat Statistik (2022), the contribution of mining sector exports to total non-oil and gas exports in 2021 had increased by 97,14% from 2020. Mining sector contributed 10.43% (5.15% y-on-y) to the GDP structure (see Table 1.2).

Table 1.2 Indonesia GDP Top 5 Contributors and Growth Rate by Industry Q4 2021

Industry	Contributions towards GDP (%)	Growth (% , yoy)
Trade	12,71	5,6
Mining	10,43	5,2
Manufacturing	18,8	4,9
Construction	10,48	3,9
Agricultural	11,39	2,3

Source: Badan Pusat Statistik (2022)

Nonetheless, the mining industry was ranked number 1 worldwide having largest increase in cases of financial restatements by the Association of Certified Fraud Examiners' Report from 2014-2018 (ACFE, 2020). Accordingly, competition and unstable economic conditions have emerged as one of the driving

forces behind earnings management in the industry (Ivana et al., 2018). The mining businesses in Indonesia exhibit a high level of rivalry, as characterized by the growth in mining demand, particularly from Europe, and price volatility in mining commodities (CNBC Indonesia, 2022). Therefore, prospective investors must exercise caution associated with earnings management practice. It is crucial to examine the factors that might affect company's earnings management in the mining sector.

The phenomenon of earnings management is related to the company's deliberate intention in manipulate earnings towards reaching a pre-determined target, which can be assessed from the measurement of Profitability, Leverage, Firm Size, Institutional Ownership, and Dividend Policy (Rahmawati & Fajri, 2021; Kurniawan et al., 2022; Kamalita, 2022; Hutauruk et al, 2022; Jumiyaniti et al, 2021; and Hasty & Herawaty, 2017).

Profitability indicates that a company's ability to generate profits and utilize assets productively over a period of time (Wibowo & Rohyati, 2018). This study will use ROA as a proxy of profitability as it considers the two ways in financing assets, which is through debt and equity (Strouhal et al., 2018). In addition, mining sector companies' operation is highly dependent on the state of its capital assets for monetization (Mareels et al., 2021). As the company's financial performance could influence external parties, such as investors, management tends to have the aim of increasing profit maximally (Hasty & Herawaty, 2017). The greater the change in ROA, the greater the fluctuation in management's ability to generate profits. Therefore, profitability could motivate management to do earnings management to

meet investors' expectations. According to the previous research, conducted by Kalbuana et al. (2022), Shahwan (2021), Lekok & Febrina (2021), Paulina & Mulyani (2018), Husna (2018), profitability has significant influence towards earnings management.

Leverage is the level of debt that a company uses for financing (Susanto et al., 2019). Leverage represents the company's level of risk, which is calculated by comparing the total liabilities of the company to the total equity of the company. Kalbuana et al. (2021) explained that as a baseline, the bigger company's debt represents the higher risk borne by company. Companies with high level of leverage rely on external loans to finance their assets. As a result, the company could be more inclined into earnings management to influence future debt negotiations (Hidayat et al., 2019). Therefore, a higher leverage could indicate earnings management as it becomes more difficult to obtain funds from external party due to the threat of default on debt repayment (Tala & Karamoy, 2017). According to the previous research, conducted by Kalbuana et al. (2021), Hidayat et al. (2019), Nalarreason et al. (2019), Agustia & Suryani (2018), leverage has significant influence towardsearnings management.

Firm size is a value that shows the size of the company assessed from total assets value, total sales, number of workers, market capitalization, and so on (Rahmawati & Fajri, 2021). The larger size of company indicates the tendency to use greater debt to meet their funding needs than small companies (Agustia & Suryani, 2018). Total assets are used because they are considered relatively stable when compared to the other indicators (Paulina & Mulyani, 2018). Given that it is

ought to be simpler to find internal and external funding sources, investors will respond more positively to large companies. On another note, small-scale companies are more likely than large-scale businesses to manage their earnings. This is because investors are more inclined to observe and pay close attention to large companies, whilst the public is more likely to disregard small companies (R. T. Putri et al., 2019). According to the previous research, conducted by Refi et al. (2022), Jumiyanthi et al. (2021), Nalarreason et al. (2019), Husna (2018), firm size has significant influence towards earnings management.

Related to ownership of a company, ownership structure can be divided into managerial ownership, individual ownership, and institutional ownership (Khurshid et al., 2019). Among those, institutional ownership has a significant impact on a company because of their capability to observe corporate management activity (Arlita et al., 2019). According to Shahwan (2021), institutional ownership occurs when banks, insurance companies, and other institutions own the majority of company's shares. Based on the data from Indonesian Stock Exchange per October 2021, institutional ownership represents 75.8% of the proportion. According to the agency theory, institutional companies may act in their own best interests or exert influence over managers to practice earnings management. Concisely, Ramalingegowda et al. (2021) explains that higher institutional ownership is related to lesser earnings management practices. According to the previous research, conducted by Jumiyanthi et al. (2021), Fairus & Sihombing (2020), Arlita et al. (2019), Oktavia (2018), institutional ownership has significant impact towards earnings management.

Dividend policy is the decision taken in general meeting of shareholders to determine whether dividends will be distributed in proportion to the number of shares held by each holder or retained as capital in the future (Pasaribu et al., 2017). Profits that are not distributed as dividends will become retained earnings (Kamalita, 2022). Dividend policy is measured by the Dividend Payout Ratio (DPR) (Dahayani et al., 2017). Companies that consistently pay dividends can be likened as companies that manage their finances well (Ridwan & Suryani, 2021). Dividend policy is said to be the motivation of managers to carry out earnings management. It is determined by the general meeting of shareholders and is not a decision of management (Wirawati et al., 2018). The profits obtained by the company are partly rights of shareholders, yet the percentage for dividends depends on management. Management expects to keep retained earnings as reserves, while shareholders wish to get high dividend payout ratio (Ridwan & Suryani, 2021). According to the previous research, conducted by Kamalita (2022), Handini et al. (2021), Hasty & Herawaty (2017), Dahayani et al. (2017), dividend policy has significant impact towards earnings management.

With the pervasive phenomenon of earnings management in the mining sector, it can be concluded that this practice is still frequently done by companies for their own benefits. Profitability, Leverage, Firm Size, Institutional Ownership, and Dividend Policy have all been found to have a significant impact on earnings management in previous research. However, the subject was focused on either manufacturing or consumer goods industry, not to mention that mining sectors contributes significantly to Indonesia's economy as well. Moreover, in prior

studies, inconsistencies of results were still present, indicating that further study is required to fill in the research gaps. As a result, the writer is encouraged to perform own research under the title of **“The Influence of Profitability, Leverage, Firm Size, Institutional Ownership and Dividend Policy Toward Earnings Management in Mining Sector Companies Listed on the Indonesia Stock Exchange”**.

1.2 Problem Limitation

To have better understanding and more focused researched, this paper does not cover every element that influence the earnings management. The studies have five independent variables and one dependent variables. The independent variables are profitability, leverage, firm size, institutional ownership, and dividend policy and the dependent variable is earnings management. Additionally, this study will be limited to the companies of mining sectors registered in Indonesia Stock Exchange within the period of 2017-2021.

1.3 Problem Formulation

The problem formulation for this study is as follow:

1. Does profitability have partial significant influence towards earnings management in mining sector companies listed on the Indonesia Stock Exchange?
2. Does leverage have partial significant influence towards earnings management in mining sector companies listed on the Indonesia Stock

Exchange?

3. Does firm size have partial significant influence towards earnings management in mining sector companies listed on the Indonesia Stock Exchange?
4. Does institutional ownership have partial significant influence towards earnings management in mining sector companies listed on the Indonesia Stock Exchange?
5. Does dividend policy have partial significant influence towards earnings management in mining sector companies listed on the Indonesia Stock Exchange?
6. Do profitability, leverage, firm size, institutional ownership, and dividend policy simultaneously have significant influence towards earnings management in mining sector companies listed on the Indonesia Stock Exchange?

1.4 Objectives of the Research

The objective of the research is as follow:

1. To examine the partial significant influence of profitability towards earnings management in mining sector companies listed on the Indonesia Stock Exchange.
2. To examine the partial significant influence of leverage towards earnings management in mining sector companies listed on Indonesia Stock Exchange.

3. To examine the partial significant influence of firm size towards earnings management in mining sector companies listed on Indonesia Stock Exchange.
4. To examine the partial significant influence of institutional ownership towards earnings management in mining sector companies listed on Indonesia Stock Exchange.
5. To examine the partial significant influence of dividend policy towards earnings management in mining sector companies listed on Indonesia Stock Exchange.
6. To examine the simultaneous significant influence of profitability, leverage, firm size, institutional ownership, and dividend policy towards earnings management in mining sector companies listed on Indonesia Stock Exchange.

1.5 Benefits of The Research

The benefits of this research are as follow:

1.5.1 Theoretical Benefit

This research is expected to contribute to the growth of scientific knowledge, particularly in the fields of financial accounting and earnings management. Apart from that, this study may be utilized as a reference and comparison to subsequent research on variables impacting earnings management. This research is anticipated to provide a better theoretical understanding of the influence of profitability, leverage, firm size, institutional ownership and dividend policy toward earnings management in mining sector companies.

1.5.2 Practical Benefit

This research also has practical benefits which are:

1. Benefits for companies

This research is expected to deliver a wider context about how the relationship of the variables – profitability, leverage, firm size, institutional ownership, and dividend policy which will allow the organization to have better decision making. With the growing trend of having a better understanding of earnings management, this research also offers practical knowledge for the writer to use it for future endeavors.

2. Benefits for users of financial statements

This research is intended to give insight into the influence of profitability, leverage, firm size, institutional ownership and dividend policy on earnings management, which will aid the stakeholders in making choices. Furthermore, this would also allow the users to make better selections.

3. Benefits for other researchers

Similar studies can be conducted in other sectors to provide additional insight on the influence of profitability, leverage, firm size, institutional ownership and dividend policy towards earnings management. Further studies can also be developed, or comparison can be developed to gain more comprehensive knowledge by researching with other variables.

4. Benefits for the government

This research is expected to give insights to regulators on the practice of earning managements, thus the potential in this sector can be maximized.