CHAPTER I

INTRODUCTION

1.1 Background

Earnings according to Tabassum et al. (2015) are "the most vital entity which demonstrate the financial stability and strength of any firm." It is the main indicator of stock prices. With that, organization will have a target amount of earnings to be attained. In order to achieve that target, managers will use what we call earnings management. Such cases like Enron, Lehman Brothers Holdings, Inc, and Signet Jeweler Limited. Enron engage in earnings management to meet the loan agreement with special purpose entities (SPEs) of Enron. It is stated that if their stock price was to reach designated level, so called the trigger, Enron would be required to provide additional stock as collateral (Knapp, 2013). Lehman Brothers use their liabilities into sales to improve their profitability. In fact, their leverage ratio depended on this to meet its targeted amount (Knapp, 2013). In 2018, Signet Jeweler Limited (SIG) found that their 2016 profit were overstated by £3.7 million and Varghese (2018) mentioned that "a number of accounts were overstated, in some cases intentionally." Which indicates the usage of earning management in order to reach a certain target.

Earnings management occurs when managers modify financial report through financial reporting judgement or chances in some business activities in order to deceive stakeholders about the company financial performance. This deceit is brought about by ensuring profit and earnings reaches its expected target (Susanto and Pradipta, 2016). Profit defined by Susanto and Pradipta (2016) as "the excess of the revenue with the cost within a certain period cannot be separated from management performance" is a measure of success of the company. Thus, earnings are manipulated through earnings management for the sake of the company's going concern.

According to Sohn (2016) "earnings can be managed in two different ways", either accrual-based earnings management or real earnings management. Accrual-based earnings management occurs through manipulating discretionary accrual choices allowed under accounting standards, usually towards the end of reporting period (Sohn, 2016). Whereas, real earnings management is executed by real activities adjustments such as timing scale of sales and production (Sohn, 2016). Finally, intentional action by managers to alter optimal business practices to change earnings in a direction is called real earnings management.

Most research uses accrual-based earnings manipulation as their earnings management proxy (Enomoto et al., 2015). Therefore, this research would address both real earnings management and accrual-based earnings management, as there has been a shift in the usage of accrual-based earnings management to real earnings management (Susanto and Pradipta, 2016). Examining only one technique of earnings management would not be able to explain the overall effect of the earnings management activities. Additionally, Gunny et al. (2014) and Enomoto et al. (2015) found that accrual-based earnings management are more prone to auditors and regulators inspection and observation rather than real earnings management. Accrual-based earnings management is also proven to be riskier as companies do not have that much flexibility in altering accruals. Ratmono (2010) and Sohn (2016) proved that real earnings management hard to be detected or proved by auditors and regulators, even those with expertise and experience.

Real earnings management is the alteration of normal operation of company into something abnormal that is led by the desire to deceive shareholders (Susanto and Pradipta, 2016). Whereas, accrual-based earnings management is the alteration in accounting method or estimates within the presentation of financial statements (Zang, 2012). The issues above are agency problems. The motivation of this research is to study how corporate governance minimize both accrual-based earnings management and real earnings management, thus reducing this agency problem. This research modifies Susanto and Pradipta (2016), the study of corporate governance to real earnings management, by adding accrual-based earnings management and several other components of corporate governance.

Corporate governance according to Man et al. (2013) is "an internal system encompassing policies, processes, and people that serves the needs of shareholders and other stakeholders by directing and controlling management activities with business practices, objectivity, and integrity." This topic has been an important tool in mitigating earnings management (Man et al., 2013). Thus, this research will discuss about how corporate governance in terms of audit committee expertise, audit committee size, managerial ownership, institutional ownership and foreign ownership are negatively influence earnings management.

Based on the above information, researcher wishes to further examine whether corporate governance has significant negative impact on earnings management as proxied by accrual-based earnings management and real earnings management. In conclusion, writer takes the title of "**THE EFFECT OF CORPORATE GOVERNANCE ON EARNINGS MANAGEMENT"**.

1.2 Research Problem

Based on background presented above, it is known that earnings management is harmful towards stakeholders, including the company itself. Said information will be obtained through financial information in the financial reports. To achieve expected target, researcher define research problems as follows:

1. Does audit committee expertise have a negative effect on accrual-based earnings management?
2. Does audit committee expertise have a negative effect on real earnings management?
3. Does audit committee size have a negative effect on accrual-based earnings management?
4. Does audit committee size have a negative effect on real earnings management?
5. Does managerial ownership have a negative effect on accrual-based earnings management?
6. Does managerial ownership have a negative effect on real earnings management?
7. Does institutional ownership have a negative effect on accrual-based earnings management?
8. Does institutional ownership have a negative effect on real earnings management?
9. Does foreign ownership have a negative effect on accrual-based earnings management?
10. Does foreign ownership have a negative effect on real earnings management?

1.3 Research Objective

In composing the objectives of the study, researcher holds on to the problem statements. The following are the objectives of the study:

1. Prove that audit committee expertise has a negative effect on accrual-based earnings management.
2. Prove that audit committee expertise has a negative effect on real earnings management.
3. Prove that audit committee size has a negative effective accrual-based earnings management.
4. Prove that audit committee size has a negative effect on real earnings management.
5. Prove that managerial ownership has a negative effect on accrual-based earnings management.
6. Prove that managerial ownership has a negative effect on real earnings management.
7. Prove that institutional ownership has a negative effect on accrual-based earnings management.
8. Prove that institutional ownership has a negative effect on real earnings management.
9. Prove that foreign ownership has a negative effect on accrual-based earnings management.
10. Prove that foreign ownership has a negative effect on real earnings management.

1.4 Significance of the Study

1. Researcher

Hopefully, the study provides deeper knowledge regarding issue being discussed experience and the application of knowledge gained during the process of learning in university.

2. Universitas Pelita Harapan

The result of this study hopefully may give additional information about application of theories taught during the process of learning, as well as additional consideration of depth of material to be taught in the process of learning in class. Additionally, hopefully the study conducted may be proper addition to literature of Johannes Oentoro Library.

3. Future Researchers

The result of this study will hopefully be able to give additional knowledge for future studies related to factors affecting earnings management, specifically corporate governance.

4. Literature Reference

The result of this study hopefully contributes to literature or research regarding the topic of earnings management in Indonesia. Especially in the areas of factors influencing the usage of accrual-based earnings management and real earnings management. Additionally, this study could contribute an additional literature consideration for managers to implement less earnings management.

5.Stakeholders

Hopefully, this study could be useful for decision making process and could contribute to framework regarding practice related to corporate governance towards earnings management. Furthermore, hopefully this study could provide new perspective for investors in their decision to invest in a company, where they invest not only by monetary measures alone, but also internal process resulting in monetary values.

1.5 Research Limitations

The research analyzed the effect of corporate governance on earnings management in manufacturing companies listed in the Indonesia Stock Exchange (IDX) period 2015 – 2017.

1.6 Systematic Research

This research paper is systematically divided into five chapters, which are:

CHAPTER I INTRODUCTION

This chapter describes the background, research problem, research objective, significance of the study, research limitations as well as systematic discussion.

CHAPTER II THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

This chapter describes basic concept definition, related literature review, conceptual framework and the hypothesis development.

CHAPTER III METHODOLOGY

This chapter describes research method used. This include the population, sample, data sources, the empirical model, operational variable definition, and method of data analysis.

CHAPTER IV RESULT AND DISCUSSION

This chapter will discuss the result and empirical findings in the research in relation to the effect of corporate governance on earnings management.

CHAPTER V CONCLUSION

This chapter consist of summary of results, conclusion, implications and limitations from the result and discussion preceding this chapter, along with recommendation for future researches.