# CHAPTER I

# INTRODUCTION

## 1.1 BACKGROUND OF THE STUDY

The growth of business in Indonesia had demanded every company to strive in the competitions of business market. Hence, every companies wish to display good financial statements as a benchmark for companies' performance. Through the financial statement, it gives the vital information about company's financial position, performance and cash flow towards both external and internal stakeholders in reliable and timely manner. It indeed helps the stakeholders for decision-making.

According to Healy and Wahlen (1999), earnings management occurs when use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers. The problem of earnings management had been faced by developed countries such as the Enron case, WorldCom case, etc. Moreover, the practice of earnings management also occurred in Indonesia sub sectors of food and beverage industry namely, PT Ades Alfindo, PT Tiga Pilar Sejahtera, etc.

One of the emerging practice of earnings management is the agency problem that cause conflict of interest between manager and shareholder (Jensen and Meckling, 1976). Managers are responsible to maximize shareholders’ wealth. However, in the other side some parties might prioritize their personal interest. Other than the agency problem, the practice of earnings management could emerge from the flexibility of manager in choosing accounting method of accrual approach. The practice of earnings management is interesting to be researched in detailed to provide a big picture from the manager opportunistic act and the personal interest. According to Leuz *et al*. (2003), Indonesia is in the group of countries with the weak investor protection which lead to high number practice of earnings management.

This research focus on the consumer goods industry as it contributed the largest structure in Gross Domestic Product (GDP) in second quarter of 2020 by 19.87% (*Kemenperin*, 2020). Despite the pandemic of COVID-19, this industry has not been significantly been affected and shows 8.8% positive value on change in the market industry in the third quarter of 2020 (*Statista*, 2021). Since 2018, Indonesian households have allocated almost 20% of their household expenditure for consumer goods products and in the third quarter of 2020, this industry has increase in the average consumer spending per trip with the food segment as the highest contribution (*Statista*, 2021). The consumer goods industries cannot be separated from human life and earn the place for the potential investors to invest (Sulaeman, 2016). With that many sub sectors from consumer goods industry, for instance food and beverage, medicine, tobacco and others. Simply said, consumer good industry provide most of the essential and daily basis needs for society. As basic needs is unavoidable in people’s life, this sector is in demand by consumers. Thus, this might attract the investor with its stable financial report and it is essential need. With the high expectation from the investors, the consumer goods companies might face the practice of earnings management. In fact, one of the oldest companies in Indonesia was PT. Tiga Pilar Sejahtera Food Tbk which publicly known to produce “Taro Snacks” established since 1990. Unfortunately in 2018, the company had been found out of performing earnings management. In the differences between the internal information and financial statement in 2017, there was later found out some critical points. Firstly, there was deduction of overstatement cost of Rp 4 trillion in the liabilities, inventory and assets with Rp 662 billion of sales and Rp 329 million of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Second, Rp 1.78 trillion with variety of scheme from PT. Tiga Pilar Sejahtera Food Tbk to other parties that affiliated by the previous management. Next, it was detected that there was no comprehensive disclosure to be shown to the relevant parties (Sources from *kabar24.bisnis*, 2021)

This is one of the essential cases from consumer goods companies that made investors, management, shareholders and relevant business parties to face anxiety and concern about the reliability of the company’s operation with the practice of earning management. The practice of earnings management happened in order to give the investor a good impression for the company to be invested. Hence, it is important for the investor to understand more about earnings management and the crucial factors that could affect earnings management in order to prevent the wrong step in the investment. This indicates that earnings management is not a new things that happen in the business world. The management who act as the agent tend to prioritize its own interest than act based on principle interest. According to Amertha (2013), the conflict between both parties (principle and agent) occur as both parties tend to priortize their own interest. In order to detect and reduce the possibility of earnings management, there are several financial ratio determinants in this research which are profitability, leverage and firm size as the controlling factor.

Profitability is one of the ratio that display the company's ability to generate profit from its asset and capital. In common, mostly investors will observe the high profitability of the companies as a result of good investment. Higher profit will generate lower risk for the investors. Hence, management will attempt in displaying that the company is in good condition. For most of the lower profitability companies, they will likely to practice the earnings management to attract the attention from the investors as well as public as a benchmark of successful company.

Leverage measure the company proportion in paying its debt. According to Ma'ruf (2006), the higher the leverage, the higher the risk that the investors will face. Hence, the investors will request for higher profit and it will lead the management of the company to practice the act of earnings management.

The size of a company is also one of the consideration of the practice of earnings management. There are two arguments on whether the firm size could have the positive or negative impacts on earnings management. The firm size may have a negative impact on earnings managements means that the larger the firm, the smaller risk of earnings management can be found as larger firms tend to have more sophisticated internal control systems. On the other hand, if the firm size may have a positive impact on earnings management which means that the larger the firm, the higher act of earnings management. As an evidence, most financial scandals were found to be done by larger firms as they have greater bargaining power with the auditors and they also have more current assets which higher ability for them to engage in earnings management. Thus, as the firm size is one of the considerations of earnings management, this research treats the firm size as a control variable in order to improve the reliability and relationship of the independent and dependent variable in this research.

Based on previous research researches about earnings management, there are inconsistent result in earnings management. Conforming to the research conducted by Komang Eva Trisma Yasa, Ni Made Sunarsih and Gusti Ayu Asri Pramesti (2020), it stated that profitability has negative and no significant influence towards earnings management. While, Dilla Febria (2020) stated that the profitability has positive significant influence towards earnings management. According to prior research of Kezia Katherine Lasmaria and Deannes Isyuwardhana (2020), the leverage has significant with negative influence towards earnings management. In contrast, Dilla Febria (2020) stated thatleverage has no significant with positive relationship towards earnings management. Referring to the previous research, Yusak Maleakhi Purnama and Eindye Taufiq (2021) concluded that the firm size has significant but negative influence towards earnings management. On the other hand, the research of

Yofi Prima Agustia and Elly Suryani (2018) concluded that firm size has no significant but positive impact towards earnings management.

Taking all of these as the essential of inconsistency result and the research gap, hence, this research is conducted for the detection and increase awareness to reduce the possibility of earnings management with the title of **"The Determinants Of Earnings Management In Consumer Goods Companies Listed in Indonesia Stock Exchange"**

## 1.2 PROBLEM LIMITATION

In accordance of the earnings management in Indonesia, this research aims to analyze the determinants of earnings management to maximize the control of earning management in Indonesia. There are many determinants trigger the occurrence of earning management but this research restricted the time and resources of determinants of earning management in consumer goods companies listed in Indonesia Stock Exchange due to the time and resources constraint. Hence, this research will focus on the determinants of profitability and leverage as independent variable and the firm size as the controlling variable of the earnings management in consumer goods companies listed in Indonesia Stock Exchange. For the period, the fundamental analysis for consumer goods companies listed in Indonesia Stock Exchange will be analyzed during the year 2018 to 2020.

## 1.3 PROBLEM FORMULATION

According to the background of the study, the formulation of this research problem can be identified as follows:

1. Does the profitability have significant impact on the earning management in consumer goods companies listed in Indonesia Stock Exchange?
2. Does the leverage have significant impact on the earning management in consumer goods companies listed in Indonesia Stock Exchange?
3. Do the profitability and leverage with firm size as controlling variable simultaneously have significant impact on the earning management in consumer goods companies listed in Indonesia Stock Exchange?

## 1.4 OBJECTIVE OF THE RESEARCH

The objective of this research is to provide answer referring to the problem formulation stated above. The objectives are as follows:

1. To determine whether the profitability partially impact on the earning management in consumer goods listed in Indonesia Stock Exchange
2. To determine whether the leverage partially impact on the earning management in consumer goods listed in Indonesia Stock Exchange
3. To determine whether the profitability and leverage simultaneously with firm size as controlling variable impact on the earning

management in consumer good companies listed in Indonesia Stock Exchange.

## 1.5 BENEFIT OF THE RESEARCH

### 1.5.1 THEORETICAL BENEFIT

The benefits of this research regarding about the theoretical benefit:

1. This research will give benefit in academic way for students to enrich the knowledge regarding the determinants of the earning management.
2. This research presents as the references for the next researcher in order to complete and enhance their research about determinants of earning management.

### 1.5.2 PRACTICAL BENEFIT

The benefits of this research regarding about the practical benefit:

1. This research will provide the relevant information for the practitioners which are the investors and shareholders regarding about the earning management and increase the awareness of the earning management in the company through the financial statements of the company.
2. This research is proposed for the companies to provide insight of the earning management's determinants and increase the awareness to anticipate the earning management occur in the practices.

3. This research is generated to contribute for the formal regulatory authorities to have the relevant review for outlining the rules and regulations clearly to rule out the actions of earning management and protect the reliability of the financial reporting of the company for the relevant users.