CHAPTER I

INTRODUCTION

1.1 Background of Study

Every company must prepare financial statements that include the information of the company transaction as well as the event that company experience during a certain period. As time goes by, company is expected to grow bigger, thus the financial statements will become crucial, either for the interest of the internal and external parties of the company. Financial statements reflect the company's financial condition during a certain period. Financial statements will be the reference for the internal party such as manager in order to make a future plan for the company and as the reference for the external party such as stakeholder in order to consider whether to establish cooperation with the company or not (Sulistyanto, 2008).

Company needs to establish a relationship with the stakeholder as the fund to operate the business is not only based on the sales activity since company will need extra fund to operate the business. The information provided by company through financial statements will be needed by the stakeholder as through the financial statements the stakeholder can access and analyze the financial condition of company. Financial statements that the stakeholder receive from the company is one of the way the company to communicate as well as to connect the company with the stakeholder as from the financial report the stakeholder can obtain more information of the company (Sulistyanto, 2008).

One of the important components in financial report is the profit earned by company in certain period as it is one of the items that the stakeholder will pay attention on (Agustia, 2013). The profit will show how the earning is generated. Based on the profit stated in the financial statements, stakeholder can measure the company financial performance in certain period as well as to decide whether the company is the right place for the stakeholder to do cooperation. The act of manager manage the company earnings in accordance with the manager wishes is known as earning management (Reviani and Sudantoko, 2012).

According to Scott (2015), earning management is a manager's choice of accounting rules or actions that is affecting the earnings in order to achieve some specific reported earning objective. As earnings information of the company will be used by the internal and external parties to evaluate the company performance, manager will have the possibility to display good earnings by conducting earning management (Pramithasari and Yasa, 2016). It is known that financial statements must be trusted as the information of the financial report will be used by the users in order to estimate the company's potential to generate profits in the future. Earning management can be a factor that will reduce the financial report credibility as well as it will make the company's financial statements become bias as it is reported with not actual condition of the financial figure (Agustia, 2013). This can make the external users to believe the financial statements made by the management as the actual profit earn by the company.

Management has the authorization and responsibilities to provide the financial report toward stakeholder, in other words manager has more knowledge of the company information rather than the stakeholder. Management is responsible to manage the company profit in order to create the well-being of the shareholder. This responsibility might cause the management to do earning management in order to show towards the stakeholder that the earning is steady.

As manager has more access towards company information, they might conduct earning management based on their own interest. The act done by management may cause the loss of other stakeholders of the company. Stakeholders will lose the trust towards the management as the produced financial statements is biased, so stakeholder are reluctant to do further cooperation with the company. It cannot be denied that management can do the earning management as management is the one who manages the earnings as well as management has the discretion to select the applied accounting method and procedure in order to achieve the specific result (Astuti et al, 2017). The various accounting methods and procedures are provided by the generally accepted accounting principles, and management has discretion to select.

According to Pramithasari and Yasa (2016), corporate governance can be one of the mechanism to minimize the behavior of manager in doing earning management. The concept of the corporate governance is to achieve more transparent corporate management for the benefits of all users of the financial statements. It is conducted by supervising and monitoring the management performance towards stakeholder. With better transparency in management, it will help growth of the company and benefit many other parties of the company (Nasution and Setiawan, 2007). To limit the manager's behavior in doing the earning management, corporate governance is needed in the company. If a company has poor corporate governance, earning management can happen in the company more easily as there is no monitoring activities from the external parties to monitor the management performance. Meanwhile, company that has good corporate governance, earning management can be reduced as there are external parties such as institutional ownership to monitor the management. The research conducted by Perdana (2019), stated that institutional ownership had a significant positive effect to earning management. On contrary, research conducted by Dini and Fipiariny (2019), stated that institutional ownership had no effect to earning management.

One of the sources of funds that a company can obtain to fund the company is debt. Leverage is to show or to measure company asset that is fund by using debt. Company that is funded by debt will drive the company to enter the debt covenant in which management has the responsibility to comply with the debt covenant. To fulfill the agreement with the creditor, management might be motivated to do earning management in order to avoid the violation related with the agreement (Wilson and Prasetyo, 2020). Company that has high leverage means that company has the possibility to do earning management as company has the proportion of high debt rather than the asset of the company (Agustia, 2013). The proportion of high debt will be the burden for the company to pay its obligation, it might make the management manage the earning according to the reported objective. By doing earning management, the company will avoid being sanctioned as unable to meet the obligation to pay the debt. According to the research conducted by Bassiouny (2016), leverage has significant positive impact to earning management. On the other hand, according to the research conducted by Wardani et al (2020), leverage did not have significant impact to earning management.

Firm size can be classified as the size of the company based on the form of big company and small company (Astuti et al., 2017). Big company will attract more investor to invest, thus having bigger burden to meet the shareholder expectation. As company has the responsibility to meet shareholder expectation, company will have the tendency to do earning management in order to meet the shareholder expectation. Big company will seek for high profit, which will cause the political cost of the company higher. In order to avoid political cost, management might manage the company earnings (Wilson and Prasetyo, 2017). In contrast, it is argued that large firm size has qualified internal controls and less possibility to do earning management as they are supervised by external parties. Firms will concern towards the firm reputation and investor trust as if the firms conduct earning management it will risk the firm to lose investor that has been built over long period of time. According to the research conducted by Elhawar and Hassouna (2021), firm size has negative and significant impact to earning management. Contrary the research conducted by Deeb and Ramadan (2020), firm size had insignificant impact to earning management.

Below is table of phenomena in which the sample of the companies are taking from the basic materials company in the period of time from 2017 to 2019. The companies that will represent the basic materials company are PT Indal Aluminium Industry (INAI) and PT Lautan Luas (LTLS).

Table 1.1 Phenomena Table of Earning Management in Basic Materials Company during 2017-2019

Companies	Year	Corporate Governance	Leverage (in times)	Firm Size	Earning Management
INAI	2017	0.7260	0.7714	27.8248	-0.0109
	2018	0.6259	0.7830	27.9679	0.0165
	2019	0.7516	0.7367	27.8240	-0.0185
LTLS	2017	0.7902	0.6756	29.3835	-0.0117
	2018	0.7779	0.6636	29.4744	-0.0118
	2019	0.7643	0.6315	29.3997	-0.0081

Source: Prepared by writer (2022)

Based on the results in the table 1.1, PT Indal Aluminium Industry (INAI) shows that there was decrease in corporate governance which is institutional ownership from 0.7260 in 2017 to 0.6259 in 2018. This will reduce the pressure of the management and it has the possibility to manage the earnings. As the results, there was increasing in earning management from -0.0109 in 2017 to 0.0165 in 2018.

From the table in PT Indal Aluminium Industry (INAI) shows that there was increasing in leverage from 0.7714 in 2017 to 0.7830 in 2018 due to company increase in bank loans for short term period as to finance the company additional raw material. In addition, there was increasing in earning management. This might happen as there is debt covenant between creditors and managers. Managers of the company has the possibility to manage the earnings in order to reach the contractual terms and to avoid the debt covenant violation.

From the table in PT Lautan Luas (LTLS) shows that there was increasing in firm size from 29.3835 in 2017 to 29.4744 in 2018 due to increase in total assets. Meanwhile, there was decreasing in earning management from -0.0117 in 2017 to -0.0118 in 2018. According to Kim et al (2003), large size firm has the possibility to reduce earning management as firm establish effective internal control structure as well as better corporate governance mechanism. This will lower the probability of the large firm to involved in earning management.

From the results of the table, it is shown that there is increase and decrease of the earning management take place within the company. The various result of the calculation in both companies shows the inconsistent result and from the result it shows that the factors that might influence the earning management are corporate governance, leverage and firm size.

From the problems that was caused by earning management and might let the third party of the company to suffer from the action done by management, writer decide to do the research that will help to give the information to reduce possibility of earning management happened in the company. Hence the research titled **"The Influence of Corporate Governance, Leverage and Firm Size Towards Earning Management in Basic Materials Company Listed on the Indonesia Stock Exchange"**

1.2 Problem Limitation

The research conducted by the writer has the problem of limitation that is to analyze whether the variable will have an influence towards the earning management. The independent variable that is use in this study are corporate governance with the indicator of institutional ownership, leverage with the indicator of total debt ratio and firm size with the indicator of log natural total asset. The object of the study in this research is in the basic materials company listed on the Indonesia Stock Exchange for the period of 2016-2020.

1.3 Problem Formulation

Based on the background of the research that has been described, then the problem that can be formulated:

1. Does corporate governance significantly influence the earning management in basic materials company partially?
2. Does leverage significantly influence the earning management in basic materials company partially?
3. Does firm size significantly influence the earning management in basic materials company partially?
4. Do corporate governance, leverage and firm size significantly influence the earning management in basic materials company simultaneously?

1.4 Objective of the Research

Based on the problem formulation that is described by the writer, the objective of the research is:

1. To identify the influence of corporate governance towards earning management in basic materials company partially.

2. To identify the influence of leverage towards earning management in basic materials company partially.

3. To identify the influence of firm size towards earning management in basic materials company partially.

4. To identify the influence of corporate governance, leverage and firm size towards earning management in basic materials company simultaneously.

1.5 Benefit of the Research

1.5.1 Theoretical Benefit

Theoretically this research is expected to give benefits for the academics by providing the information regarding with the earning management and how are the influence of corporate governance, leverage and firm size towards earning management. This research is expected to give information and can be used as reference for the future researchers that are going to conduct the same research.

1.5.2 Practical Benefit

Practically this research is expected to give benefits towards:

1. Investors

This research is expected to provide knowledge and information of how the influence of corporate governance, leverage and firm size towards earning management. As by having the knowledge and information of the factors that can influence the earning management, investor can be more careful in invest money to the company that might have the indication in doing the earning management.

2. Companies

This research is expected to provide the information of the factors that can trigger the management for doing the earning management and how the company prevents the earning management happening by understanding the factors that can influence the earning management. This can also help the company gain a good reputation and the investor trust to invest to the company.