CHAPTER I

INTRODUCTION

1.1 Background

When a company carry out an operational activities, the need for an accountability report is vital for every year because from this report, the performance of the company in the relevant year can be analysed and evaluated. Also by evaluating it, whether for the present or even the future, the company's management or decision-maker can make the best decision for the company. The reason for doing this is because in this world where we live, it is always about competition and so does the company. Each company in the world has their own competitor and if they don't maintain their performance and the existence of the company, they will be wiped out from the market. The report that is mentioned above which are used to analyse and evaluate the performance of the company is called the financial report or financial statements.

External parties used the report as source of information regarding the company. Reports that describe a company's financial situation at the moment or during a specific time period are referred to as financial statements. (Kasmir, 2019). Usually the first part of financial statements that were checked by the external parties are the profit/loss statement because these statement reflects the company performance.

The situation of the company will be shown by the information in the financial statements, and the manager's skills and knowledge will be crucial to providing good financial reports. Because of profit/loss becoming one of the strong basis in evaluating the company, the management of companies will do their best do modify their profit when the actual profit that was originally stated in the report didn’t meet the expectation of the target that had been set by the management. In doing so, when the modified it is presented to the public or the external, it can attracts them and will have a good reputation. This action is what called as earning management.

According to Kasmir (2017), earnings management is a condition where management intervenes when compiling a financial reports for stakeholders where the manager will make an effort to increase or decrease the profit. So, the management will try to find a loophole to fixed the problem with the desired result but also with following the rules that is set in accounting standards. Earnings management behavior is related to agency theory which assumes unequal goals or conflicts of interest between manager of an entity with shareholders. Amri (2020) stated that agency theory is a theory that provides an explanation for the working relationship that exists between management and business owners (shareholders). The theory suggests that firm value cannot be maximized unless appropriate incentives or appropriate oversight are effective enough to prevent company managers from using discretionary profit optimization techniques. This theory shows that there is a delegation of principals (shareholders) to company managers

to run a company. Therefore, principals always have to do appropriate monitoring on the agent's performance to reduce the possibility of conflict that might occur.

There are some earning management cases that happen in the reality which one of them is the case about PT. Tiga Pilar Sejahtera Food Tbk (AISA) in 2017. This is a company that engaged in food and beverage sector which was suspected for doing earning management in their financial report for 2017. In the investigation that was conducted by PT Ernst & Young in March 2019, it was found that the old board of directors had inflated funds worth IDR 4,000,000,000 in the annual financial statements, and also accused IDR 662,000,000,000 of gains and other EBITDA (earnings before interest, tax, depreciation and amortization) of IDR 329,000,000,000 inflation. Another finding of the investigative report was that funds of IDR 1,780,000,000,000 were flowing through the various systems of the AISA Group to parties suspected of being linked to the old management. In addition, it was also found that there were relationships and transactions with affiliated parties that did not use an adequate disclosure mechanism to relevant stakeholders. (Sources from CNBC Indonesia, 2019).

Until now, this practice of earning management still becomes a debatable phenomena. On one side, it is clear that this is categorized as a fraud because of the manipulation of the financial report by the manager to be adjusted to the desired purpose while on the other side, this practice is accepted because although doing earning management, the manager still strictly follow the methods that are set in accounting standards. Eventually, earning management will bring negative effect because this will affect the decision making for the sake of company future that are

made by the decision maker whether it is internal or external parties. Profit of the company will be the benchmark for the parties to make a decision both in cooperation or investment so this is the basis for the manager or internal parties to do earning management with the purpose to manipulate financial report to create a good company economy situation.

After the explanation about earning management above, then it is important to know what is the factors that encourage earning management practice. The first one is profitability. Kasmir (2016) stated that profitability is the ratio that measures a company's capacity to generate profit. Additionally, the ratio provides a measure of a company's management's efficiency. The revenue from investments and sales profits can serve as indicators of this. The primary objective of this ratio is to demonstrate the effectiveness of the business. Profitability can be made as benchmark to analyse the job that has been done by the companye management. If the company generates huge profit, then the manager himself can get accolade such as bonus while if the company suffer a huge loss then the manager will be considered as incompetent so this is the reason why the earning management is conducted so that the company can continue to be viewed favorably by external parties and also the performance and performance of the company is considered good.

The second factor that encourage the management to do earning management is leverage. From the explanation in Investopedia, financial leverage emerges when an organization chooses to fund the vast majority of its resources with obligation or debt. In addition to acquiring additional assets, financial leverage

can be used to fund a project or investment. Debt is taken from loans with various sources, especially banks. In return, the company promises to repay the principal and interest on the loan. Leverage ratio is a measure of how much of its assets are financed by debt. This indicates the ratio of the company's debt to its assets. (Kasmir, 2019).

Operating leverage and financial leverage are the two types of leverage. Operating leverage is the ability of a company to use fixed operating costs to increase the impact of changes in sales volume on EBIT. This type of leverage arises as a result of the burden or fixed costs that the company have to takes on in its operational activity. The use of operational leverage is expected to affect sales and generate higher profit before tax and interest. Financial leverage is the use of fixed-cost funding sources, assuming that they will provide additional returns greater than the fixed costs, thereby increasing the profits available to shareholders. This type of leverage arises from various fixed financial expenses that the company has to bear.

External parties or shareholders are keen to look at the leverages of the company because through this, they will be able to determine the extent to which the business is capable of turning a profit sufficient to cover its current expenses and return the invested capital. The higher of the leverage ratio of the company then there is higher possibility of fraud that will occur in the company and this indication is expected because an entity with a high leverage ratio allows the magnitude of creditor risk to occur. This is because it is assumed that the company will not be able to fulfill its obligations (default) on time. With that assumption companies tend

to try to avoid high levels of leverage ratios to create good financial report results in front of the shareholders shares or other interested parties, both investors and creditors.

The third factor is tax avoidance where this is a method is a way to avoid paying taxes legitimately by reducing the amount of tax payable by looking for weaknesses in the existing regulations. This practice happen because of both government and company have their own interest. From government perspective, tax is a source of income while from company perspective, tax is a source of expense and therefore management strives to pay as little tax as possible and tax avoidance is a legitimate way for the company to do in order to reduce their expenses. On the government side, if the company conduct tax avoidance, then this can result in barriers to tax collection, as well as reduced the income of the country. As a result, managers have a number of options for reducing the company's tax burden, including implementing tax avoidance strategies and manipulating profits to lower taxes.

In terms of the research itself, the writer chose to focus on the consumer goods companies because it is one of the most fundamental parts of human life and makes a big contribution to Indonesia's Gross Domestic Product (GDP). In the first quarter of 2022, the industry generated more than one-third or 37.77% of GDP for non-oil and gas processing industries (Kemenperin, 2022). The consumer goods industry also become the strategic industry by investors to invest in by looking at its huge potential as this industry covers many vital and basic needs for society such as food and beverages, medicine, houseware, tobacco, etc. Therefore, in order to

convince the investors, the practice of earning management are being seen as one of the solution to manipulate the financial statements to look promising to be invested.

Based on the explanation above, writer are encouraged to carry out research with title **“The Impact of Profitability, Leverage and Tax Avoidance on Earnings Management in Consumer Goods Companies Listed on the Indonesia Stock Exchange”** There are differences with the previous one, because this research adding an independent variable in the form of tax avoidance which in the research previously rarely studied related to earnings management.

1.2 Problem Limitation

As there are many determinants that can trigger earnings management practice, the writer due to time and resources constraint had to made the discussion more focused and aligned with objectives to be achieved. The following are the research problem limitations:

1. The Consumer Goods Companies are chosen by the writer as the object of this research with a certain period from 2018 to 2020.
2. For this research, the independent variable (X) are Profitability (X_1), Leverage (X_2), and Tax Avoidance (X_3) while the dependent variable is Earnings Management (Y).

1.3 Problem Formulation

The following is the formulation of the research's problem based on the background and limitations outlined in the previous section:

1. Does Profitability have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange partially ?
2. Does Leverage have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange partially?
3. Does Tax Avoidance have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange partially?
4. Do Profitability, Leverage, and Tax Avoidance have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange simultaneously?

1.4 Objective of the Research

The following are the research objectives, as stated in the problem formulation:

1. To understand whether Profitability have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange partially.
2. To understand whether Leverage have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange partially.

3. To understand whether Tax Avoidance have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange partially.
4. To understand whether Profitability, Leverage, and Tax Avoidance have significant effect on Earnings Management in Consumer Goods Companies listed on Indonesia Stock Exchange simultaneously.

1.5 Benefit of the Research

The writer anticipates that this study will benefit both theoretically and practically, such as:

1.5.1 Theoretical Benefit

Theoretically, the writer expect this study to serve as a literature source for theoretical research, as well as for other scholars who wish to further study earnings management. The writer also hopes that the findings of this study will make people more aware of and understand how profitability, leverage, and tax avoidance affect earnings management.

1.5.2 Practical Benefit

Practically, the writer expects that this research will be useful for:

1. Writer

   The research can provide better understanding regarding The Impact of Profitability, Leverage, and Tax Avoidance towards Earnings Management.

2. Investor

   It is hoped that this study will provide investors with additional information to take into account when responding to information contained in a company's published financial statements and when making a decision.

3. Company

   This research can provide useful information for the company in analyzing and making the right decision on the financial report.