CHAPTER I

INTRODUCTION

1.1. Research Background

The financial statements are one of the source of information that can be used by external parties for decision making. According to International Accounting Standards (IAS) 1, the objective of general purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. Good financial statements include all information that is relevant and useful for investors and other users. This is consistent with the objective of financial statements which is to generate information about financial position, capabilities and changes in the financial position of an entity that is useful to users in making economic decisions.

One of the financial statements that indicate the company's performance for a given period is income statement (Ujiyantho and Pramuka, 2007). Income numbers provided in the financial statements has the ability to affect users of the information in making decisions regarding to the company. Earnings information is part of the financial statements that are often modified through opportunistic actions of management to maximize their own benefits. Actions concerned with their own interests is done by managing the earnings so that profit can be adjusted, increased, or reduced in their own desire, such behavior is known as earnings

earnings management. Earnings management happens because of agency problems related to the separation of ownership and control. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the company's economic performance or to influence contractual outcomes that depend on reported accounting numbers (Healy and Wahlen, 1999).

Earnings management is still an ongoing phenomenon and important to be investigated particularly in Indonesia. Leuz in Eny (2015) found an empirical evidence related to earnings management practice in Indonesia that Indonesian company is indicated engaging earnings management, where earnings management level in Indonesia is higher than several countries i.e. Malaysia, The Philippines, Singapore, and Thailand as Indonesia is at number 15 from 31 sample countries. Kittiakrastein and Srijunpetch (2014) also found that earnings management level in Indonesia compared to another five countries in South East Asia (ASEAN countries) is relatively high as Indonesia is in the third order after Vietnam and Thailand in terms of earnings management.

Earnings management can be done either through accrual or real activities manipulation. Accrual manipulation is done by manipulating discretionary accruals. The accrual-based earnings management is related to unreasonable change in accounting policy or accounting estimates (e.g. the useful life of assets, the residual value of assets, the amount of doubtful accounts) and change in accounting choices (e.g. depreciation method) to meet target earnings numbers (Kiattikulwatana, 2014). The amount of discretionary accruals is depending on management's decision; therefore, company's earnings can be increased or decreased by depending on managers' interest.

Real activities manipulation is earnings management done by the managers which deviate from normal business practices aimed of achieving certain earnings (Roychodhury, 2006), such as giving price discounts to boost sales, overproducing product to reduce fixed overhead costs, and cutting or delaying discretionary costs. Even though earnings management practice does not violate the accounting regulation, it may decrease the quality of earnings reported because it does not reflect the real situation of the company; therefore, it is necessary to reduce earnings management practice.

Commonly, nowadays managers have more tendency to apply real activities manipulation rather than accrual. There are two reasons behind this condition. First, accrual manipulation often becomes the center of observation or inspection by the auditors and the regulators. Second, focus attention only on accrual manipulation is a risky action because the company may have limited flexibility to manage accrual (Graham et al., 2005).

Earnings management happens not only by the opportunistic management actions, but also occurs due to lack of management supervision and control of the company that may cause agency problem as explained in agency theory, where a principal (the owner) hires an agent (the other person) to provide service to the principal by delegating authorities to the agent. By delegating authorities, it means that principal is authorizing the agent to manage the company. The agent as the manager of the company are obligated to signal about the company's performance to the owner. However, there is a possibility that information submitted to the owner are not reflecting the real situation of the company, where the situation is known as information asymmetry (Haris, 2004).

Information asymmetry is where one party has more or better information than the other. This creates an imbalance of power in transactions and bring opportunities for the managers to manage the earnings (Richardson, 1998). According to the agency theory, the presence of institutional and managerial ownership may reduce the information asymmetry (Jensen and Meckling, 1976).

Institutional ownership as one of the main components in the agency theory is an ownership percentage of ordinary shares held by financial institutions. Ownership by financial institutions will potentially increase the control and monitoring in the company. According to Jensen and Meckling (1976) institutional ownership plays an important role in order to minimize agency conflicts between managers and shareholders. The institutional shareholders, different than common shareholders, have ability and knowledge that do not belong to common shareholders so they can provide more active monitoring that is difficult for smaller, more-passive or less-informed investors (Almazan, Hartzell and Starks, 2005), making them possible to reduce the ability of managers to opportunistically manipulate earnings (Alves, 2012). Therefore, the higher institutional ownership will lead to higher monitoring process from investor toward management in order to limit earnings management practice.

According to the agency theory, managerial ownership is able to reduce the agency problem caused by information asymmetry. Managerial ownership is an ownership percentage of ordinary shares held by the management of a company. The management is CEO, directors, and managers of the firm (Alves, 2012). Earnings management is strongly influenced by the motivation of the company's managers. Different motivations will result in different level of earnings management, such as the manager who also serves as shareholders and managers who do not serve as shareholders. This happens because the financial statements are made by the managers who make the financial statements and financial performance are evaluated based on what they have made by their selves. Less qualified financial statements will be more likely to happen because the managers do not serve as owners of the company. The segregation of ownership will result in a conflict in controlling and company’s governance which make the managers do not perform what they should do, which is to maximize shareholders’ profit.

The information asymmetry associated with the separation of ownership and control between principals (owners) and agents (management) create demand for external audit (Gerayli et al., 2011). The auditor is expected to reduce information asymmetry because auditor acts as an external party (outside of the firm) to verify the validity of the financial statements, where financial statements are made by the management as the agent and used by the owners as the principal. According to DeAngelo (1981), audit quality is auditors’ capability to detect material misstatements in financial statements and report the material misstatements. A good quality auditor also acts as an effective deterrent of earnings management because management would be punished and the company value would be low due to fake financial reporting if it is detected and exposed. Qualified auditors were able to reduce the level of accrual earnings management (Becker et al., 1998; Johnson et al., 2002; Balsam et al., 2003). This will lead to inflexibility of auditors' clients. When companies experience accounting inflexibility, companies will use real earnings management as an alternative (Ewert and Wagenhofer, 2005) in Radityo (2013). As a consequence of obstructed access to engage accrual earnings management, the clients will switch to real earnings management when companies have a strong incentive to manage earnings (Radityo, 2013).

Firm size serves a proxy of political cost, considered to be very sensitive in case of earnings management behavior (Watts and Zimmerman, 1986). Firm size is commonly used for political cost guidelines, where political cost increases along with size and risk of the firm. Following the theory, earnings management is practiced by the company because the management has a motivation to lower the number of earnings thus the political cost will decrease. Bigger companies have more demand and pressure from companies' stakeholders to make company shows its performance as they demanded compared to small and medium firm. This situation makes the management of big firm need to fulfill the stakeholders' demand, as they have more tendency to report positive earnings by practicing earnings management compared to small and medium firm (Barton and Simko, 2002). In the other hand, different empirical result was found by DeGeorge et al., (1999) and Kim et al., (2003), where they found a contrary result that every company, regardless of its size, evidently have reported positive earnings in order to avoid earnings decreases or earnings losses.

This research can reveal the earnings management practice done by the management. It also gives advices to any potential investors before deciding to invest in some companies listed in Bursa Efek Indonesia (BEI) so investors can be more cautious before they make an investment decision.

Based on the background above, this research is given a title of **"The Impact of Ownership Structure, Audit Quality, and Firm Size toward Earnings Management through Real Activities Manipulation".**

1.2. Research Questions

Based on the background, therefore research questions are formulated:

1. Does institutional ownership have a negative impact toward real earnings management?
2. Does managerial ownership have a negative impact toward real earnings management?
3. Does audit quality have a positive impact toward real earnings management?
4. Does firm size have a negative impact toward real earnings management?

1.3. Research Objectives

The objective of this research is to prove empirically:

1. The impact of institutional ownership toward earnings management through real activities manipulation.
2. The impact of managerial ownership toward earnings management through real activities manipulation.
3. The impact of audit quality toward earnings management through real activities manipulation.
4. The impact of firm size toward earnings management through real activities manipulation.

1.4. Research Contributions

This research is expected to contribute in several aspects:

1. Investors, Creditors, and Interested Parties

This research can give a contribution in theory relating to the impact of ownership structure, audit quality, and firm size toward real earnings management practice in Indonesia. A good governance limited to institutional and managerial ownership, quality audits, and firm size may not absolutely give quality financial statements, as there is a possibility to find any real activities manipulation in financial statements. Therefore, investors should be cautious and have a deep fundamental analysis in order to decide which company to invest to.

2. Academicals

This research can be used as a reference for the next research related to earnings management in real activities practice particularly in Indonesian companies.