CHAPTER I
INTRODUCTION

1.1 Background of the Study

In assessing the performance of a company, one of the sources of information used is a financial statement. According to Ikatan Akuntan Indonesia (IAI) in PSAK No. 1, 2015, financial statement is a result of an accounting process that shows on the financial position and company performance that is beneficial to most of the user that are involved in economic decision-making. Profit is generally most important anxiety in measuring the enactment or administration culpability. Therefore, management has a tendency to perform an action to improve the financial report, one of that action are managing or manipulating the profit of the company.

Every year the company needs to issue financial statements for evaluating company performance. Financial statements are concise notes that contain financial information of a company in a certain period which is a form of management responsibility for the resources provided by the owner. In addition, financial statements are also a form of accountability to external parties such as investors, creditors, customers, employees, and the community, as the basis for economic decision making. This is completed for the reason that in the financial report the firm's recital is reflected during a period.

The measure that often been used to assess the success or the failure of a management system in a company can also be seen through the profit that has been obtained by the company. Profit is one of the important information for the

external parties such as investor and creditor who used profit as an indicator performance of a company. Managers as an internal part of a company certainly have more information compared to external parties. This condition triggered by internal parties to take corporate actions to report earning that does not reflect the actual company performance or called earning management.

Earning management is intermediation management in the procedure of preparing a financial statement for external parties to even, increase or decrease the earnings report, where management can use an accounting method, create policies that can accelerate or delay cost and revenues. Earning management also defined a management strategy to deliberately manipulate the company's earnings so that the figures match a pre-determined target. This practice is carried out for the purpose of income smoothing (Iraya, Mwangi & Muchoki 2015).

Gonzales and Meca (2013) point out that weak corporate governance structures can offer managers with the opportunity to engage in behaviors that ultimately result in lower report earnings quality, which is a solid indication of business ethics. Corporate governance is a scheme whereby corporations are concentrating and well-ordered by several parties: directors, auditors, and shareholders. Corporate governance decision making was responsible by Board of Director. The auditor is in authority for improving the recital of the corporation, specifically from the control aspect.

Earnings management actions are familiar to academics, practitioners and relevant parties used as a monetary statement. Earnings management seems to have become a corporate culture practiced by all corporations in the whole world

because of earning management activities not only happen in developed nations but also in emerging nations, one of them is Indonesia.

The higher value of corporate governance not only enhances the development of the corporation but also offers such a robust toolkit to avoid management from committing unprincipled conducts and scam management. Effective structural organization, conclusion procedures, and the confirmation of the board directors particularly determine the worth of the corporate governance. (Nguyen, 2016)

The earnings controlling detection model is a technique used to quantity earnings management in a company. Jones model is the initial earnings management detection model that was introduced by Jones in 1991 which was established by Dechow *et al*., in 1995 acknowledged as Modified Jones Model. Modified Jones model efforts to precise the weaknesses of the Jones model which only uses earnings changes by adding fluctuations in receivables to model estimates. The estimation undertakes that all variations in credit sales are the effect of manipulation. The differences between changes in earnings and changes in receivables also mean that the modified Jones model uses total cash income that scientifically understands the amount of earnings management (Stubben, 2010). Overall, estimation of modified Jones models using accrual aggregates.

Some weaknesses of the modified Jones model also started to be expressed such as cross-sectional estimates that indirectly assume that companies in the same industry produce the same accrual process. In addition, the accrual model also does not offer information for components dealing with corporate

earnings where the accrual model does not separate discretionary rises in earnings over income or component costs (Stubben, 2010). Looking at the weaknesses of research on earnings management, Stubben in 2010 established a model that uses more factors to predict earnings management. According to Skinner and Bernard in 1996 accrual models have been disparaged for provided that biases and disruptive estimations of policy, which inquiry the decisions of research using the accrual model.

According to Stubben (2010), income is an ideal component to test earnings management because income is the largest component of profit for most corporations and depends on policy. This model is termed the conditional revenue model. In his research, Stubben (2010) found evidence that conditional revenue models are more actual in detecting earnings management. Even so, this model hasn't been broadly used in earnings management research. Experimental lessons on the detection of earnings management in Indonesia also haven't used conditional revenue model because the most common technique for estimating earnings management is the accrual model that has been habitually used in earnings administration research and most still use a modified Jones model.

On the basis of Stubben's (2010) dissatisfaction with the accrual model, research on the measurement of earnings management with the revenue model is conducted. This revenue model is dissimilar from the accrual model that has been regularly used in earnings management measurements so far. The revenue model uses accrual receivables rather than accrual aggregates as a function of income

changes. According to Stubben, accounts receivable have a direct and solid empirical relationship with income.

Stubben (2010) conducted research with simulation and actual procedures in spotting income and expense manipulation using the accrual model and revenue model. Stubben's (2010) research displays evidence that the revenue model was biased lower, more specific, and then stronger than accrual model normally used. This result provides support for using discretionary revenue in identifying earnings management.

From the existence of two dissimilar models, namely the Modified Jones Model and the Conditional Revenue Model, this research was carried out. Until now there is no definitive evidence to define the most effective model that can be applied in identifying earnings management for companies in Indonesia. This is because, in Indonesia, research in identifying earnings management always uses an accrual model. The research entitled Comparative Analysis of Accrual Model and Revenue Model of Corporate Governance to Earnings Management: Manufacturer Companies Listed on IDX to compare both models.

1.2 Problem Statement

The sample used in this observation is all listed manufacturing companies listed on The Indonesia Stock Exchange (IDX). The motive for examining manufacturer companies is for the reason that manufacturer business in Indonesia these days is increasing constantly, as the same of increasing earnings management deceptions. This observation is fascinating on this topic to know whether the manufacturing

firms are more frequently to influencing and controlling the earnings management or not.

The actions of manipulating the earnings management have raised some cases of accounting reporting is widely known in Indonesia such as PT Agis Tbk (AGIS) and PT Inovisi Infracom (INVS). In the case of PT Agis based on the results of examination by BAPEPAM (Capital Market Supervisory Agency, 2007) AGIS has proven to provide information that is not related materially to revenues from 2 acquired companies namely PT Akira Indonesia and PT TT Indonesia, which stated that the second income The company is 800 billion Rupiah, however, based on the financial statements of the two companies to be acquired as of March 31, 2007, the total income was only around 466.8 billion Rupiah. AGIS also violates the consolidated financial statements of their subsidiaries. In the AGIS Consolidated Profit and Loss Statement, Net Other Income of 29.4 billion Rupiah was disclosed which originated from the AGIS Electronics Financial Report as a subsidiary of AGIS which was not supported by competent evidence and errors in the application of accounting principles. With thus other income in the AGIS Financial Report is not reasonable which results in the AGIS Consolidated Financial Statements are also not reasonable. (http://www.bapepam.go.id//siaran-pers, posted on December 17, 2007, accessed on February 08 2019, at 21:25)

The case of PT Inovisi Infracom (INVS) in 2015. In this case, the Indonesia Stock Exchange (IDX) found indications of misstatement in the INVS financial report for the period of September 2014. In the information disclosure of INVS dated February 25, 2015, there were eight items in the INVS financial

report repaired. IDX asked INVS to revise the value of fixed assets, net income per shares, business segment reports, financial instrument categories, and total liabilities in business segment information. In addition, the IDX also stated that INVS management misstated items of cash payments to employees and net receipts (payments) of related party debt in the cash flow statement. In the first semester period 2014 payment of salaries to employees of Rp1.9 trillion. However, in the third quarter of 2014, the salary payment rate for employees dropped to Rp59 billion. Previously, INVS management had revised its financial statements for the period from January to September 2014. In the revision, some of the values in the financial statements had changed in value, one example of which was the decrease in the value of fixed assets to Rp 1.16 trillion after the revision from previously recognized was Rp 1.45 trillion. Inovisi also recognizes earnings per share based on current period profit. This practice makes INVS's earnings per share look bigger. In fact, the company should use the current period profits attributable to the owners of the parent entity (http://www.bareksa.com, posted on February 25, 2015, accessed on February 08 2019, at 22:45 WIB)

1.3 Research Question

Stubben (2010) developed a Conditional Revenue Model as a detector of earnings management that involves changes in accounts receivable and changes in income as components that have direct empirical relationships. While the modified Jones model (Dechow, *et al*., 1995) uses the basis of entire accruals and real income obtained through the difference between changes in income and

changes in accounts receivable. The researchers started to find weaknesses in the accrual model and look for alternatives to other models.

Build upon the research background above, the problems of this study are as follows:

1. In what way the board size significantly work on earnings management?
2. In what way the board independent significantly work on earnings management?
3. In what way the ownership concentration significantly work on earnings management?
4. In what way the institutional ownership significantly work on earning management?
5. In what way the managerial ownership significantly work on earning management?

1.4 Research Objectives

1. To determine whether board size has significantly affected to earnings management.
2. To determine whether the independent board has significantly affected earnings management.
3. To determine whether ownership concentration has significantly affected to earnings management.
4. To determine whether institutional ownership has significantly affected to earnings management.

5. To determine whether managerial ownership has significantly affected to earnings management.

1.5 Research Contribution

1. Writer

The writer is inclined to admit further approximately corporate governance and earning management on IDX companies, mainly in the manufacturing company in Indonesia. This study will provide the writer with a deeper thoughtful of earnings management in the actual action. It as well could be as the writer next study orientation.

2. Firm

Outcomes are estimated to offer information to companies concerning the factors that would assist to retain suitable company employees to let them contribute to knowledge sharing even more.

3. Investor

This study is expected to understanding the preparation of earnings management conducted by the company so that investors can be more cautious and can take better investment decisions.

4. Academics

Used as orientation for further study especially for the research on trust and obligation of members in a company setting.

1.6 Systematic of Writing

To aid further discussion, detailed and clear, the systematic discussion is organized as below:

CHAPTER I: INTRODUCTION

This chapter comprises the background of the study, problem statement, research question, research objectives, and contribution and the writing systematic.

CHAPTER II: THEORETICAL FRAMEWORK AND HYPOTHESIS

This chapter contains the supporting previous research topics, literature, theoretical framework, an explanation of the research that has been done before as well as the basic model of research. Advanced section of this chapter is the formulation of the research hypothesis.

CHAPTER III: RESEARCH METHODS

This chapter consists of the approach used in the study, ranging from research outline, research subject, the operational definition of the variables used and data collection techniques. This chapter also discusses the data analysis methods used in the study, which consisted of descriptive statistical analysis, outlier test, and panel regression.

CHAPTER IV: ANALYSIS AND DISCUSSION

This chapter describes the analysis of the collected data processing research through statistical testing tools and will be listed the results of the analysis.

CHAPTER V: CONCLUSION, LIMITATION AND RECOMMENDATION

This chapter contains the conclusion of the study, limitations of the study and recommendations can be given for future research.