CHAPTER I
INTRODUCTION

1.1 Background

Earnings – the bottom line of financial statement, refers to the profit that a firm generates from its revenues after deducting all associated expenses. That is, every increment in economic benefit has been seen as earnings. Earnings and its attribute are the main concern of financial performer. Firm valuation is yielded through the performance of firm in the short run and long run which is indicated by firm earnings. Therefore, firm earnings is closely associated with firm valuation. Investors and creditors value a firm through the capability of it in generating earnings. Investors prefer a firm with stable earnings and creditors were unlikely to borrow their money to a negative earnings firm. For that matter, release of concurrent information around earnings announcement show that there's an increase in market response to earnings announcements (Beaver, McNichols, & Wang, 2019). These phenomena obviously emphasize the relation between firm value and earnings. Significance of earnings as valuation of the firm is the mastermind of accounting scandal. Consistent with the theory of fraud triangle, financial targets served as a rationalization to commit manipulation (Sukirman & Sari, 2013).

Managers' ability is also argued to affect the quality of earnings. Study found out that managers' ability would increase firm efficiency and decrease the possibility of earnings restatement, which will increase earnings quality eventually (Edi & Suyadi, 2018). Moreover, managers are found to perform aggressive accounting choice and risk taking behavior in financial reporting (Kim, 2015). Managers intentionally exploit the loopholes in financial regulations and accounting choice to obtain inappropriate benefits (Bhasin, 2016). The financial motivations are simply external factors of earnings management. Knowing only the external factors is never sufficient to detect earnings management. Internal factors such as firm characteristics and the way stakeholders govern the firm are also the key points to detect earnings management.

Firm characteristics have strong impact on earnings management behavior. Some of them will accentuate the earnings management behavior, while others will

attenuate it. Firm size, firm leverage, and firm financial performance are all found to have significant impact on earnings management (Charfeddine, Riahi, & Omri, 2013). Large firms might have larger incentive to perform earnings management compared to small firms (U. Ali, Noor, Khurshid, & Mahmood, 2015). Managers are argued to have motivation in performing earnings management to outstrip financial threshold (Doyle, Jennings, & Soliman, 2013). In addition, corporate governance mechanism and audit quality might limit managers' opportunity to engage earnings management. Higher audit quality are found to increase earnings predictability therefore might reduce opportunistic behavior (Hussainey, 2009). Furthermore, effective corporate governance mechanism is also believed to constraint earnings management behavior (Salim & Hn, 2019).

The act of earnings management of course have caused the financial instrument cannot perform as guidelines in making decision (Walker, 2013). The fraudulent financial statement will only provide a misleading information. That is, investors and creditors should not only depend on financial statement in analyzing a firm's financial condition. Certain external and internal factors would be a great help in assessing firm's financial condition instead of those fraudulent financial statements. The research of "The Influence of Firm Characteristics and Corporate Governance Characteristics on Earnings Management" is therefore compelling because it provides a new perspective on what conditions will facilitate earnings management, and how financial performer can recognize the earnings management practice. By analyzing firms listed in Indonesia Stock Exchange, this research offered empirical evidence on showing in what circumstance earnings management is performed.

1.2 Research Urgency

In early 2019, managers of PT Garuda Indonesia is summoned by Indonesian Stock Exchange (IDX) shortly after its financial statement publish. The flight company owned by state is discovered to have earnings manipulation during the accounting period of 2018. The state owned company is found to manipulate earnings by recognizing unearned revenue of $239.94 million. The manipulation is deliberately conducted by managers disregard the opposition of the commissioners to make the performance looks better than the prior year.

Earnings management not only happened in Indonesia but also a phenomenon around the world. In May 2015, Japanese giant technology company stir up the world with an internal accounting scandal. Toshiba had been discovered to manipulate an earnings of $1.22 billion. This manipulative action is conducted by Toshiba managers to reach a targeted earnings. In that time, Toshiba was actually suffered a loss of $8 billion. The findings of this scandalous action led Toshiba to revise its earnings for three years.

After a year of Toshiba scandalous action, in 2016 a Canadian drug-maker company, The Valeant Pharmaceuticals' executives were caught for overstating its revenue by recognizing it earlier. Valeant recognize a roughly $58 million as sales to Philidor – a pharmacy vendor which Valeant severed ties with, when the firm delivered its drug. According to accounting standards, the revenue should be recognized after the drugs were sold out to customers. This scandalous incident caused a huge plunge on its stock price which had fallen from $262 to under $27 in a short time.

Recently in August 2019, US's financial watchdog – the SEC conduct investigation towards General Electric. General Electric was suspected to commit bigger fraud than Enron, the accounting fraud it committed is worth for $38 billion which is over 40% of the firm's market capitalization. Again, with the similar manner, the General Electric's managers concealed an approximately $29 billion of losses from the public and is heading to bankruptcy.

Accounting fraud is also involving start-up firms in Silicon Valley. In early 2019, WeWork, the unicorn start-up firm whose public offerings is the most expected event is burst out. WeWork suffered substantial losses over years. In 2016,

it suffered $429 million of $436 million in revenue, and continually to suffer loss. In 2019, the firm reported loss of $690 million of $1.5 billion in revenue. Poor corporate governance is pointed as the reason behind the problems faced by WeWork. Multi class share structure had given the CEO more power than other shareholders that resulted in numerous of abnormal accounting practices. The CEO was reported to lease his private property to WeWork, conduct loan for himself and other executives with low and zero interests.

Other than WeWork, Theranos – the blood testing start-up is reported to inflate revenues from an actual figure of $100.000 to $100 million. The accounting scandal turned the high valued firm of $10 billion to bankruptcy in a short time. Due to the fraud, investors of Theranos suffered myriad of losses. Cases mentioned above suggested that in this century, accounting fraud is no longer an occasional event. The research emphasized on this urgency to reveal what factors are apparently affecting earnings management behavior.

1.3 Research Questions

To enhance the comprehension on factors affecting earnings management, the following research used a few proxies to measure the various aspects in a firm. Financial performance, firm size, and leverage are used to measure the financial condition of the firm. In other hand, this research used board of directors' size and auditor's size as measurements of corporate governance. Furthermore, the research studied certain activity that could trigger the act of earnings management, for example share issuance.

Built upon issues mentioned above, the author tried to answers these following research questions:

1. How does financial performance influence earnings management?
2. How does firm size influence earnings management?
3. How does leverage influence earnings management?
4. How does board of directors' size influence earnings management?
5. How does auditor's size influence earnings management?
6. How does share issuance activity influence earnings management?

1.4 Research Purposes and Benefits

1.4.1 Research Purposes

The research is carried to accomplish these purposes:

1. To discover and analyze the influence of financial performance to earnings management.
2. To discover and analyze the influence of firm size to earnings management.
3. To discover and analyze the influence of leverage to earnings management.
4. To discover and analyze the influence of board of directors' size to earnings management.
5. To discover and analyze the influence of auditor's size to earnings management.
6. To discover and analyze the influence of share issuance activity to earnings management.

1.4.2 Research Benefits

The discoveries of this research might bring benefits for several parties, including:

1. Findings of the research might help external fund providers like investors, creditors, shareholders, and monitoring boards of firm in monitoring managers' behavior especially for firms in Indonesia. Abnormal accruals might be a signal of earnings management behavior. This research provide empirical evidence showing how to recognize earnings management behavior and under what circumstance that it could be performed. Therefore, earnings management behavior could be detected and even prevented.
2. The research might help financial regulators in improving financial and accountancy regulation to improve investment environment, such as investor protection policy, corporate governance policy, and disclosure regulation.
3. The presence of this research provide a new insight towards corporate governance mechanism and firm characteristics. Further research might

built on this research in exploring earnings management from a new perspective.

4. As a contribution to academics, the correlation testing of discretionary accruals model present the precise method to define earnings management behavior in Indonesia. The outcomes of the research would eliminate the uncertainty of model's suitability possessed in numerous existing models of discretionary accruals.

1.5 Research Structures

In order to coordinate the whole research, the research are conducted under the following structures:

CHAPTER I INTRODUCTION

In the introduction, authors have specified about background underlying the research topic, research questions that would be the research objects, research scopes, research purposes and benefits that might be accomplished through the research, along with the research structures.

CHAPTER II LITERATURE REVIEW & HYPOTHESES GENERATION

In this chapter, author showed the previous researches' model along with the theoretical basis which are the main considerations and references in this research.

CHAPTER III RESEARCH METHODS

In this part, author describes the research layout, along with methods and approaches that are used in the research process, starting from data collecting process to data analyzing process.

CHAPTER IV ANALYSIS AND DISCUSSION

In this section, author analyzed the discoveries of the research thoroughly and conduct discussion regarding the

coherences between research discussion and the research propositions determined.

CHAPTER V **CONCLUSIONS AND RECOMMENDATIONS**

In this segment, author summarize the overall research's discoveries and providing recommendations for further researches.