CHAPTER II
LITERATURE REVIEW AND HYPOTHESES GENERATIONS

2.1 Earnings Management

Numerous researchers have been conducting studies regarding earnings management. Factors as firm characteristics, corporate governance characteristics, and particular firm activity have been reported have significant impact on earnings management behavior (N. H. Dang, Hoang, & Tran, 2017). In this research, earnings management behavior was represented by discretionary accruals modeled by (Dechow, Sloan, & Sweeney, 1995; Jones, 1991; Kothari, Leone, & Wasley, 2005). Consolidated financial statement, executive duality role, firm performance, firm size, and share issuance activity are found to have significant positive relationship with earnings management behavior. In other hand, auditor size as proxy of audit quality and financial leverage have significant negative relationship with earnings management behavior. Additionally, board of directors' size have an insignificant negative impact on earnings management.

Identifying earnings management behavior is an essential issue that researchers have been working on. The capability of accrual models to identify earnings management behavior have been tested (Peasnell, Pope, & Young, 2000). The findings of this research suggested that cross sectional abnormal accruals model have capability to detect accruals based earnings management. Both standard discretionary accruals model and modified discretionary accruals model have been proved are more capable at identifying revenue and bad debt manipulation earnings management. In other hand, margin model is more capable at identifying non bad debt manipulation earnings management.

Furthermore, characteristics of earnings management is also a big concern. Investigation to explore relations between characteristics of earnings management behavior and future profitability in south-east Asia countries have been conducted (Wardani & Kusuma, 2012). The study revealed that characteristics of earnings management in south-east Asia countries (Indonesia, Philippine, Singapore, Thailand, and Malaysia) is not similar. By focusing on accruals based earnings management and real earnings management, the researchers found out that real

earnings management is less aggressive in Indonesia and Philippine compared to the others countries. In contrast, accruals based earnings management is higher in Indonesia and Philippine compared to the others countries. Additionally, the study discovered that earnings management is opportunistic in Indonesia and Malaysia, but informational in Thailand and Philippines.

Table 2.1 Theoretical Framework

No	Authors	Year of Publication	Findings
1.	Dang, Hoang, & Tran	2017	Firm characteristics, corporate governance characteristics, and certain firm activity have significant impact on earnings management behavior.
2.	Peasnell, Pope, & Young	2000	Cross sectional abnormal accruals model have capability to detect accruals based earnings management.
3.	Wardani & Kusuma	2012	Accrual based earnings management is higher than real earnings management in Indonesia and Philippine compared to other south-east Asia Countries. Earnings management in Indonesia tends to be opportunistic.

Built on above theoretical framework, this research is conducted to investigate the influence of firm characteristics, corporate governance characteristics, and firm certain activity on earnings management behavior (N. H. Dang et al., 2017). Cross sectional and time series discretionary accruals model will be used to identify the earnings management behavior (Peasnell et al., 2000). Finally, this study will be focused on accrual based earnings management behavior, as it is high in Indonesia (Wardani & Kusuma, 2012).

2.2.1 Earnings Management Definition

It has been a common knowledge for every financial statements reasonable users that stated figures in earnings probably be affected by accountant's choices and discretions. Earnings management is an act of manipulating earnings. Manipulate is explained as the capability of management to add or reduce earnings at will (Copeland, 1968). Earnings management has been discovered as a phenomenon in financial reporting process whereas managers of a firm attempted to exhibit a fair earnings quality report to satisfy the high expectation of financial statements users (Francis, Huang, Rajgopal, & Zang, 2008). By conducting

earnings management, managers turned earnings as the report of their enthusiasm instead of as the result of firm financial performance (Levitt, 1998). The definition of earnings management have led us to think about the subjectivity in accounting process and how earnings management is committed.

2.2.2 Earnings Management Environment

Accounting standards enable comparability and enhance information environments (Horton, Serafeim, & Serafeim, 2013). Timely recognition of loss is supposed to reduce the scope of earnings management (Iatridis, 2010). Flexibility is supposed to enable managers to have freedom to choose accounting alternatives that fit to the firm current situations. Moreover, business model in this era is rapidly changing. It is no longer possible to make all firms applying the same accounting principles on different transactions. That is, flexibility in accounting standards is essential and desirable in this rapidly changing economic.

However, current accounting standards allowed too much flexibility for management and eventually resulted in accounting subjectivity (Parfet, 2000). Flexibility of accounting standards might be abused to conceal negative earnings and breed instability (Mügge & Stellinga, 2015). The principle based accounting standards do not possess enough construct to restrain managers' discretions in applying those principles on accounting process (Wüstemann & Wüstemann, 2010). Flexibility in IFRS has become a loopholes that enable larger room for subjectivity that intensify earnings management (Callao & Jarne, 2010). Therefore, there might be a need of additional regulations to attenuate the act of earnings management.

Transition of ownership structure from owner-manager to a separated owner and manager structure have caused appearance of agency relationship between shareholders and firm managers. Agency relationship is interpreted as an indenture that occurs when a principal involved an agent to work in the name of the principal, along with the entrustment of authority in decision making (Jensen & Meckling, 1976). Agency theory points out two problems that arises as the consequence of agency relationship. The primary agency problem was desires conflict between principal and agents, another agency problem is risk sharing problem (Eisenhardt, 1989).

Conflict between principal and agents happens because the agent (firm's managers) as decision makers have contrasting interest with the principal (shareholders) who are the residual claimants (Fama & Jensen, 1983). Risk sharing problem arises as the principal and agents have contrasting risk preference or risk attitudes, therefore might take different actions (Eisenhardt, 1989). When managers engage decision that favor their own interests over the owners' interests, the managers then will attempt to manage earnings in a particular way to cover up those doings (Fuad Rahman & Mohd - Saleh, 2008). That is, earnings management occurs as the managers mislead their wrongdoings through a managed earnings.

Investors uncertainty about the firm value is surrounded around two elements, shared fundamental uncertainty among owners and managers, and information asymmetry that was caused by the nature of financial reporting aberration (Beyer, Guttman, & Marinovic, 2019). Information asymmetry is described as market uncertainty that occurred when a particular party have more access to information compared to other parties in a relationship (Akerlof, 1978). In the term of a firm, managers are the parties who have more access compared to shareholders.

Larger discretion and control over firm information have enable the managers to manage earnings. That is, the high level of information asymmetry would become an obstacle for shareholders to have enough incentives, information, and access to monitor managers (Richardson, 2000). In contrast, earnings management is more likely to be discovered under a liquid and transparent market (Cormier, Houle, & Ledoux, 2013). Under the information asymmetry condition, managers are encouraged to choose distinct financial reporting alternatives (Chaney & Lewis, 1995). Therefore, the existence of information asymmetry in a firm is a required condition for earnings management (Trueman & Titman, 1988).

2.2.3 Real Earnings Management and Accruals Based Earnings Management

Broader definition of earnings management postulated that earnings management can be engaged through several approaches. Sure enough, there's two approaches of earnings management, the first approach is based on cash flow basis

– real earnings management and another approach is based on accruals basis – accruals based earnings management. Real earnings management is conducted by the managers through real activity manipulation. Real activity manipulation is described as an activity of managers to mislead financial statements users to be convinced that certain financial goal had been achieved through a deviated operational activities decision (Roychowdhury, 2006). Accruals based earnings management is interpreted as involvement of managers' choices and discretions in preparing financial statements and constructing transaction, to provide misleading information regarding the financial condition of the firm (Healy & Wahlen, 1999).

Operational activity decision certainly will affect the cash flow. In other hand, accruals based earnings management might not essential to have impact on the cash flow (Cupertino, Martinez, & da Costa, 2015). Compared to accruals based earnings management, real earnings management is harder to discover, yet more costly (Kothari, Mizik, & Roychowdhury, 2016). Therefore, manager is predicted to commit accruals based earnings management prior to commit real earnings management. That is, a lot of researches (including this paper) are focused on accruals based earnings management to explain the activity of earnings management (Dechow et al., 1995; Healy, 1985; Jones, 1991; Kothari et al., 2005).

2.2.4 Techniques and Schemes of Earnings Management

Firm managers attempt to fulfil external fund providers' eagerness and prediction regarding firm performance which is shown through earnings. Earnings management is conducted through vast and various techniques and schemes. The techniques and schemes of earnings management is literally an abuse of core accounting and financial principles (Levitt, 1998). Common core accounting and financial principles that are being misemployed are:

1. The revenue recognition principle
2. The expense recognition principle or the matching concept
3. Conservatism principle

The core accounting and financial principles are being misemployed through the techniques and schemes of earnings management namely the big bath, creative acquisition accounting, cookies jar reserves, and the revenue recognition.

Earnings management using the big bath schemes occurs when firm encountered a negative earnings. Instead of increasing earnings the managers might as well decreasing earnings. When firm faced a tremendous low performance and it is not possible to manipulate earnings to meet prior earnings forecast, firm managers might likely to recognize more expenses (Yoon & Miller, 2002). The rationale is that when current performance is bad, the possibility to increase the earnings in next period is much higher. That is, by committing the big bath schemes managers try to give a wrong signal to investors that firm's earnings is growing.

The managers performing big bath by utilizing the impact of bad news regarding the firm financial performance. Revelation of bad news have greater effect on stock rather than good news (Kothari, Shu, & Wysocki, 2009). Under this circumstance, managers tend to retain bad news as long as possible. Therefore, when the bad news cannot be concealed anymore, managers will choose to worsen the situation under the conservatism principles. Big bath is found to increase information asymmetry among deceptive managers and investors (Hope & Wang, 2018).

Other studies discovered that managers tend to perform big bath during management changes. During management changes, there's a notable reduction in earnings and discretionary accruals decision (Moore, 1973). Incoming managers have a tendency to decrease earnings in the first year of their tenure, while departing managers have tendency to decrease earnings in the last year (Pourciau, 1993). This is because new managers tends to be more pessimistic in the first year of tenure. Furthermore, it is easier to increase earnings growth while the prior earnings is low.

Creative acquisition accounting is described as an act of expanding particular accounting standards by financial professionals in order to turn the strict accounting standards into an elastic standard, and use that to achieve some desires that cannot be achieved with the strict standard (Archer, 1996). Managers in a low growth but surplus free cash flow firm might commit creative acquisition accounting by choosing earnings increasing accounting practices (Rusmin, W. Astami, & Hartadi, 2014). The way managers choosing particular accounting practices to fulfil their own desires is the so called rationalization in the fraud triangle (Reskino & Anshori, 2016). Moreover, unfair power authorization of

regulators (macro manipulation) and manipulation of financial statement figures to mislead financial statement users at organization level (micro manipulation) are both involved in creative acquisition accounting (Gowthorpe & Amat, 2005).

Loopholes in accounting standards have been utilized by professionals as a room for manipulation and performing creative acquisition accounting. There are several loopholes that been utilized for performing creative acquisition accounting (Vinnari & Näsi, 2008):

1. The implementation of accrual basis accounting system, which does encourage creative acquisition accounting instead of providing a transparent and reliable accounting information.
2. Accounting regulations for public sector is deliberately customized for national use, it is even looser compared to the general accounting standards. Therefore, open much more room for public sector to commit creative acquisition accounting.

Creative acquisition accounting encompasses compliance in accounting standards, however it does deviate from the original purpose of those standards. To get creative acquisition accounting done, there's always an involvement of professionals such as lawyers, auditors, and even regulators in the "creative compliance", to give public a sense of credibility in this complicated manipulation scheme (A. K. Shah, 1996). That is, creative acquisition accounting is camouflaged by the creative compliance. Common ways to perform creative acquisition accounting are managing capitalization process of the research and development expense, choosing the most favorable accounting practices (for example: depreciation methods and inventory measurement methods) (Yadav, Kumar, & Singh Bhatia, 2014). However, the behavior of creative acquisition accounting will always evolve along with the changes of transactions natures and accounting standards (Dechow & Skinner, 2000). Therefore, the complexity and diversity of transactions and accounting standards have become obstacles in fixing the creative acquisition accounting problem (S. Z. A. Shah, Butt, & Tariq, 2011).

Cookies jar reserve techniques is performed by creating reserves in well performance period, retain those reserves, and recognize those earnings in later poor performance period (Caylor & Chambers, 2015). Study reveals that bank use

reserves account in financial statements not only to avoid earnings decline (either it is compared to prior period or peer company), but also to attenuate earnings fluctuation (Bornemann, Kick, Memmel, & Pfingsten, 2012). The concept of cookies jar reserve is similar to the conservatism concept of the accounting principle, where financial statements preparer are supposed to expect viable future losses and no earnings. That is, managers abuse the conservatism concept to delay earnings recognition.

There are several financial statements accounts that usually be used as cookies jar reserve tools:

1. Impairments of assets, managers are found to recognize impairment loss in well performance period and reverse those losses in bad performance period to avoid earnings decrease (Duh, Lee, & Lin, 2009).
2. Allowances for uncollectible accounts, where managers recognized over accruals in prior well performance period to bring down bad debt expense in the future (Jackson & Liu, 2010).
3. Deferred tax accounts, managers are found to manipulate deferred tax accounts when earnings before tax is below financial forecast (Herbohn, Tutticci, & Khor, 2010; Kasipillai & Mahenthiran, 2013).
4. Effective tax rate, managers deliberately over estimate and reserve quarterly effective tax rate, and utilized it when financial performance miss the earnings target (Comprix, Mills, & Schmidt, 2012).

Revenue must be recognized whenever performance obligation is achieved. According to accounting standards, revenue must be recognized when it is realized or realizable and earned. That is, every revenue recognition that deviates from the standard is indicating the act of manipulation. Managers are found to escalate revenue recognition to boost earnings before tax when it missed the financial experts' forecast (Levitt, 1998). Credit revenue manipulation tend to be manipulated in earnings management. Earnings management by managing credit revenue is easier than managing cash revenue (Dechow et al., 1995). Additionally, managers use strategic revenue recognition by utilizing both deferral sales account and accrual sales account to avert earnings uncertainty (Caylor, 2010).

2.2 Prior Researches and Literatures

Umpteen of variables that are argued to affect earnings management have been investigated. A meta-analysis have been conducted to investigate relationship between audit quality and corporate governance to earnings management behavior (Lin & Hwang, 2010). The findings proposed that independence and expertise of board of directors in corporate governance characteristics have negative impact on earnings management behavior. Moreover, auditor size, tenure, and specialization along with auditor independence as proxies of audit quality also have been found to have negative impact on earnings management behavior.

Empirical evidence suggested that the independence of audit committee can attenuate the positive relationship between high level of free cash flow and earnings management behavior (Bukit & Iskandar, 2009). By using listed firm in Malaysia as sample, the research discovered that there's incentive for managers to commit earnings management when free cash flow is high. However, this condition can be controlled by effective monitoring by the role of audit committee. Overall, it suggested that higher independence of audit committee can attenuate the earnings management behavior.

In other hand, firm diversification factor either industrial diversification or geographical diversification is argued have influenced the engagement of earnings management (Khanchel El Mehdi & Seboui, 2011). The research conducted univariate and multivariate analysis to discover relationship between firm diversification factor and earnings management behavior. It summarized that geographical diversification provide a complimentary environmental for engaging earnings management as the agency theory hypothesized. In contrast, industrial diversification is found to decrease the earnings management behavior.

Several researches are concentrated on the impact of ownership structures on earnings management. Research built on incorporation between firm ownership structures and national level institutional factors are conducted to examine how those predictors affect earnings management behavior (Bao & Lewellyn, 2017). The research contributed empirical evidence that controlling ownership reinforced earnings management behavior, whereas investor protection policy can attenuate that relationship. In addition, the research reveal that the high quality regulatory can

augment the negative relationship between institutional ownership and earnings management practice. Overall, it concluded that the interaction between ownership structure and national level institutional factors can affect the earnings management behavior. Furthermore, certain ownership structures such as internal managerial, institutional, external block holder, foreign, and family ownership have been proved to limit earnings management practice and enhance financial reporting quality (Saleem Salem Alzoubi, 2016).

Study focused on certain industry have also been emphasized. Study discovered that banks are utilizing available for sale assets (AFS) for committing earnings management (Barth, GGmez Biscarri, Kasznik, & LLpez-Espinosa, 2014). Applying analysis on both listed and unlisted banks, the study found that AFS does capacitate banks to commit earnings management in several mechanisms. Banks with positive earnings or have AFS gains tend to smooth earnings, whereas banks with negative earnings have a tendency to manage earnings by using big bath method.

Firm's executives, such as Chief Executive Officer (CEO) have been discovered to have incentive to commit earnings management (A. Ali & Zhang, 2015). The outcomes of this study proposed that CEO prompt to engage earnings management to gain market's positive perception regarding their performance (ability). Other studies revealed existence of woman directors on board have influence on earnings management (Arun, Almahrog, & Ali Aribi, 2015). The authors suggest that in less complex firm, woman directors will positively influence earnings management practice.

Lastly, certain firm's activity such as share issuance activity also be found could motivate managers to engage earnings management (Wang & Hagigi, 2019). By investigating all share issuance events, the study discovered that mangers in firm with low necessity of subsequent stock issuance are more potential to engage earnings management. In contrast, managers will unlikely to engage earnings management in firm with high necessity of subsequent stock issuance. When managers have high necessity of subsequent share issuance, they tend to be more attentive to future earnings and will avoid activity that will lower future earnings.

Table 2.2 Prior Researches and Literatures

No	Authors, Year of Publications	Independent Variables	Dependent Variables	Conclusions
1.	(Wang & Hagigi, 2019)	Equity Issuance	Earnings Management	Mangers in firm with low necessity of subsequent share issuance are more potential to engage earnings management
2.	(Bao & Lewellyn, 2017)	Ownership structure, minority shareholder protection, and regulatory quality	Earnings Management	The controlling ownership reinforced earnings management behavior, whereas investor protection policy can attenuate that relationship. The high quality regulatory can augment the negative relationship between institutional ownership and earnings management practice.
3.	(Saleem Salem Alzoubi, 2016)	Ownership structure	Earnings Management, financial reporting quality	Internal managerial, institutional, external block holder, foreign, and family ownership have been proved to limit earnings management practice and enhance financial reporting quality.
4.	(A. Ali & Zhang, 2015)	CEO tenure, CEO age, and CEO ownership	Earnings Management	Chief Executive Officer (CEO) have been discovered to have incentive to commit earnings management.
5.	(Arun et al., 2015)	Number of female directors	Earnings management (both in low debt and high debt condition)	In less complex firm, woman directors will positively influence earnings management practice.
6.	(Barth et al., 2014)	Realized gain or loss on AFS, Net income before taxes	Earnings smoothing, regulatory capital management	Banks with positive earnings or have AFS gains tend to smooth earnings, whereas banks with negative earnings have a tendency to manage earnings by using big bath method.
7.	(Khanchel El Mehdi & Seboui, 2011)	Industrial (business) diversification, geographical diversification	Earnings Management	Geographical diversification provide a complimentary environmental for engaging earnings management as the agency theory hypothesized. In contrast, industrial diversification is found to decrease the earnings management behavior.
8.	(Lin & Hwang, 2010)	Board of directors' independence, expertise,	Earnings Management	Independence and expertise of board of directors have negative impact on earnings

		ownership; audit committee's existence, meetings, independence, size, expertise, ownership; auditors' tenure, specialization, size, and independence		management behavior. Auditor size, tenure, and specialization along with auditor independence have been found to have negative impact on earnings management behavior.
9.	(Bukit & Iskandar, 2009)	Free cash flow, audit committee	Earnings Management	The independence of audit committee can attenuate the positive relationship between high level of free cash flow and earnings management behavior.

Over last decade, plenty of researches carried to investigate earnings management behavior. In summary, those predictors are regarding firm characteristics and governance characteristics. Therefore, current research are designed to obtain empirical outcomes about relationship between firm characteristics and governance characteristics using different proxies from prior researches.

2.3 Factors Affecting Earnings Management

Firm characteristics is described as organization internal factors that emerged within the internal environment of the organization itself and can be controlled which encompasses management influences and firm competencies (Zou & Stan, 1998). Furthermore, firm characteristics is categorized into seven classes: valuation, investment, prior returns, earnings, financial distress, external financing, and other class (Kogan & Tian, 2012). In this research, firm characteristics included are firm size to reflect valuation, firm performance to reflect earnings, leverage to reflect financial distress, and stock issuance activity to reflect external financing.

Mechanism of ownership and control to protect minority rights, legal inhibition against management self-benefit behavior is called corporate governance (Shleifer & Vishny, 1997). Therefore, corporate governance characteristics is reasoned as attentive oversight characteristics that reflected best practice to prohibit management discretion and restrict their ability to respond to the potentials of a financial crisis which is believed would bring detrimental effect towards a firm

(Van Essen, Engelen, & Carney, 2013). The studies encompassed board of director's size to reflect board characteristics and auditor's size to reflect audit quality.

Predictors of earnings management behavior that will be examined in this research encompasses three scopes: firm characteristics, corporate governance characteristics, and certain firm activity. Firm performance, firm size, and leverage are predictors in firm characteristics. Board of directors' size and auditor's size are predictors in corporate governance characteristics. Share issuance activity is predictor in certain firm activity. All of the predictors' effect on earnings management will be talked over specifically as below.

2.3.1 Financial Performance and Earnings Management

Financial performance is the main concern of external parties – investors and creditors in assessing firm's value. Executives' compensation scheme are based on firm financial performance. The possibility to engage earnings management become higher when executives' compensation are based on firm financial performance (Sun, 2014). That is, financial performance have become a motivation for managers to engage earnings management behavior.

Managers have a tendency to engage earnings management to satisfy financial thresholds in three conditions:

1. To avoid negative earnings in current performance. By using firms in Singapore and Thailand as sample, researchers found that firms in Asia prompt to eliminate pre-managed negative earnings through discretions and resulted in reporting positive earnings to elude losses or negative earnings (Charoenwong & Jiraporn, 2009).
2. To sustain firm financial performance. Study found out that the engagement of earnings management is not only for avoid negative earnings but also to avoid declined earnings (Amar & Abaoub, 2010).
3. To fulfil analyst's prognosis. Managers manage the determination of earnings by reporting earnings exclusions and special items to fulfil and exceed analyst's prognosis (Doyle et al., 2013).

Moreover, study also revealed that there's significant market compensation for firms that fulfil analyst's prognosis. By comparing firm that missing analyst's prognosis and firm that meeting analyst's prognosis, the research suggested firm that meeting analyst's prognosis by manage accruals expense downwardly will gain short run share price benefit (Bhojraj, Hribar, Picconi, & McInnis, 2009). The findings highlighted the manager's motivation in engaging earnings management behavior that is associated with financial performance. That is, by mean of earnings management behavior, reported financial performance is expected to be higher. Build upon the exposition above, therefore the first hypotheses in this research is

H_1: Financial performance has positive and significant influence on earnings management.

2.3.2 Firm Size and Earnings Management

Insistence to have a better financial performance, larger possession of assets, and negotiation power to bargain with auditors provided large firms opportunity and motivation to engage more earnings management (U. Ali et al., 2015). According to the political cost assumption, large firms might have higher political cost and under more public attention, therefore large firms will engage more earnings management behavior (Rusmin, Scully, & Tower, 2013). The research discovered that when firms will conduct upward earnings management whenever current earnings is below prior earnings. In contrast, firm will conduct downward earnings management whenever current earnings is above prior earnings.

Large firm will reduce the quality of earnings and governance mechanism including audit quality and earnings predictability. Auditors will probably impede earnings management behavior engaged by small firm than large firm. Audit partners in non-big four are found to compromise audit independence for financially significant clients (W. Chi, Douthett, & Lisic, 2012). The predictability of earnings is found lower is large firm due to the higher probability of earnings manipulation to elude negative earnings and government intervention (Ahmed AL-Dhamari & Nor Izah Ku Ismail, 2014). Moreover as firm size increase, family firms will more

possible to engage in earnings management behavior (Martin, Campbell, & Gomez-Mejia, 2016).

Large firms have more complicated and complex transaction compared to small firm, thus large firm is more prompt to engage earnings management (N. H. Dang et al., 2017). This notion sustain the fraud triangle theory, whereas complicated and complex transaction will enable manipulation. Furthermore, there's higher extent of management and ownership separation in large firm. The higher information and agency risk faced by large firm are believed to enable managers to conduct earnings management (Nalarreason, T, & Mardiati, 2019). Other study revealed that large firm prompt to utilize discretionary accruals in placing their seasonal share issuance (Shu & Chiang, 2014). Based on explanation above, therefore the second hypotheses in this research is

H_2: Firm size has positive and significant influence on earnings management.

2.3.3 Leverage and Earnings Management

The extent of how the firm utilize debt for asset financing is called leverage. Firms obtain its financing either from creditors in the form of debt or from investors in the form of equity. Creditors and investors are argued to monitor firms that they funded in. Study found out that short term liability is positively associated with earnings management behavior only strong for low creditworthiness firms (Fung & Goodwin, 2013). That means, when monitoring benefits outweigh financial distress incentive, the positive association can actually be reduced. Monitoring mechanism of borrowing entity – creditors therefore is essential. Firms' earnings management behavior is found decreasing when bank monitoring mechanism's efficiency increased (Ahn & Choi, 2009). The level of leverage is found low in pre-merger and acquisition firms which engage in upward earnings management behavior (Alsharairi & Salama, 2012). These findings sustain the control theory, where external monitors will increased as managers obtain new loans therefore will decrease the agency problems. Additionally, another study also find that distressed firms are actually less possible to commit earnings management because those firms will used up all means for engaging earnings management (Ghazali, Shafie, & Sanusi, 2015).

When level of debt comparatively low, the regression of debt on earnings management is found negative. In contrast, when debt is high, the regression is found positive (Alzoubi, 2018). This is because when debt is high, motivation to avoid covenant violation outweigh the benefit of providing high financial reporting quality. Debt is also found to reduce positive earnings management engagement in high transparency and low diversified firms. In opposite, debt is found to incline positive earnings management in low transparency and high diversified firms (Rodríguez-Pérez & van Hemmen, 2010). Additionally, intensified leverage limiting manager's opportunistic behavior due to strict monitoring therefore alleviate accrual-based earnings management however exacerbate real earnings management (Vakilifard & Mortazavi, 2016). According to the elucidation above, therefore the third hypotheses in this research is

H_3: Leverage has negative and significant influence on earnings management.

2.3.4 Board of Directors' Size and Earnings Management

There are two types of board structure over the world, one-tier board and two-tier board. One tier board allow a same person in charge of chairman and chief executive directors, while two tier board doesn't allow that. Indonesia adopt a two tier board system, therefore board of directors in this research doesn't include supervisory board. According to Indonesian limited liability firm's regulation (UU PT), board of directors are firm's structure that have full authority and in charge of the management of a firm, represent the firm, and act in accordance to firm's objectives.

Although board of directors supposed to act in accordance to firm's objectives, managers as agents might have interest conflict with owners. Directors are in charge of firm's daily operation and therefore possessed more information of firm compared to owners which increase information risk. That is, consistent with agency theory and information risk hypothesis, executives will behave in their own interest, thus have incentive to conduct earnings management. Investigation towards the relationship between corporate governance and earnings management, provide evidence that larger board size are associated with more earnings management behavior (Swastika, 2013).

Large size of board of directors is argued to represent a malfunction of governance mechanism. When the board of directors is large, it is harder for the directors to communicate and make decision. Empirical evidence revealed that large board size vision a failure of board advisory and monitoring role, and caused an negative influence on firm performance (Guest, 2009). A positive relationship between board size and earnings management appear as board's members increases up to seven members (Geraldes Alves, 2011). By categorizing board size, research found out that board size of nine to twelve members are involved with higher earnings management behavior (Epps & Ismail, 2009). These findings suggest that smaller board does provide more effective monitoring role compared to large board. An unduly large board will cause monitoring mechanism become ineffective (Veronica Siregar & Bachtiar, 2010).

Furthermore, while investigating the association between board characteristics and opportunistic earnings management, research emphasized that compared to other elements, quality of board is the most essential elements in governance mechanism (Payal & Singh, 2017). It also revealed that existence of controlling shareholder as executives in a firm will exacerbate earnings management. In accordance to the explication above, therefore the fourth hypotheses in this research is

H_4: Board of directors' size has positive and significant influence on earnings management.

2.3.5 Auditor's Size and Earnings Management

Auditor's size is one of audit quality's attribute. Numerous of researchers show that the greater auditor's size is the audit quality will be greater. Earnings quality therefore will be improved along with the high audit quality. Earnings predictability are found higher when firms are audited by big four auditors compare to non-big four auditors (Hussainey, 2009). Big four auditors are argued to compete with each other on audit value – price and quality by subsidizing in audit technology along with the market size (Sirois & Simunic, 2011). In addition, big auditors are more likely to preserve their independence compare to small auditors (W. Chi et al., 2012). In summary, big four auditors are revealed to reduce earnings management

behavior effectively compared to non-big four auditors for several reasons (Rusmin, 2010):

1. Big four auditors have higher motivation to preserve their reputation in international level, thus will improve their audit quality.
2. Big four auditors have higher independence compared to non-big four auditors, non-big four auditors may reduce their objectivity to retain a single client.
3. Big four auditors have more qualified resource in technology, human, and capital that enable them to provide high audit quality.

Other studies revealed that big four auditors will be able to reduce earnings management behavior under several circumstances. Enforcement on legal system and legal environment can directly affect audit environment. Big four auditors will be capable to alleviate earnings management behavior under sufficient negligence mechanism (Yasar, 2013). By comparing international legal environments, research revealed that big four auditors constraint earnings management behavior in effective legal system audit environment (Memiş & Çetenak, 2012). Posit on the description above, therefore the fifth hypotheses in this research is

H_5: Auditor's size has negative and significant influence on earnings management.

2.3.6 Share Issuance Activity and Earnings Management

Share issuance activity is another way to obtain financing from external fund provider – equity financing. Investors will more consider to put their money in a high performance firm. Firm with low performance will get less financing compared to high performance firm. Earnings management is engaged in order to meet financial threshold and analysts' forecast so that firm's share price will soar up in the short run (Bhojraj et al., 2009). Income increasing earnings management resulted in equity overvaluation (J. (Daniel) Chi & Gupta, 2009). That is, earnings are managed upward to constitute investors' optimist view regarding firm growth and performance. Therefore, having a high performance during share issuance become incentive for managers to manage earnings.

Earnings management not only conducted during initial public offerings but also seasoned equity offerings. Research discovered that firms which issue multiple seasoned equity offerings will continuously manage discretionary accruals to raise earnings (Chang & Lin, 2018). The empirical evidence show the cumulative pattern of discretionary accruals accompanying share issuance from prior share issuance to current share issuance. Moreover, firms are found to engage in both real and accrual-based earnings management during seasoned equity offerings (D. A. Cohen & Zarowin, 2010).

Although earnings management increase earnings during share issuance, but numerous studies found out earnings will decline after share issuance. By analyzing long run performance, the study revealed that firms that managed earnings aggressively during initial public offerings suffered poor share returns after several periods (Yang, Hsu, & Yang, 2013). Furthermore, researchers documented three movements of discretionary accruals during share issuance (Miloud, 2014):

1. Discretionary accruals will grow before share issuance period
2. Discretionary accruals will reach the peak on the share issuance period, and
3. Discretionary accruals will decline after share issuance period.

Other study also proposed that earnings management around seasoned equity offerings engaged by large firm is positively associated with short term performance and negatively associated with long term performance (Shu & Chiang, 2014). Postulate on the findings above, therefore the last hypotheses in this research is

H_6: Share issuance activity has positive and significant influence on earnings management.

2.4 Research Model and Hypotheses Generations

This research proposed a model which separates the predictors of earnings management into two groups. The first group are those predictors that accentuate earnings management behavior, while another group are those that limit earnings management behavior. Firm performance, firm size, board of directors' size, and

share issuance activity are primarily assumed to have significant and positive influences on earnings management. In other hand, leverage and auditors' size are hypothesized to have significant and negative influences on earnings management. In addition, accrual based earnings management is measured through discretionary accruals models.

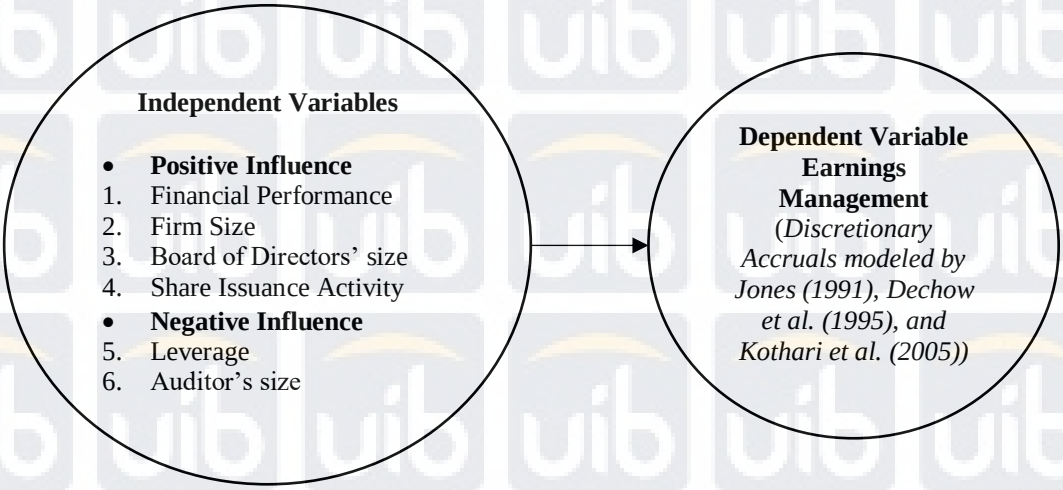

Figure 2.1 Research Model