

# CHAPTER I INTRODUCTION

## 1.1 Background and Need

Have good quality of financial report is really important for a company, because financial statements are the records of a company's performance information in an accounting period. It is also a tool for investors and creditors to make financial decisions (Van Beest, Braam, & Boelens, 2009). According to the Financial Accounting Standards, financial statements aim to provide information relating to the financial position, income statement, and changes in equity of a company that can be used by a large number of users in order to make financial decisions.

To have a good quality of financial statements, the financial statements need to be audited by an independent auditor to maintain their objectivities. Good quality of financial statements mean that there is no any significant errors or mistakes made by the managers, whether it is on purpose or accidentally. Because it is often to happen where managers and shareholders have different goals eventhough they are in the same company. This kind of situation, we often call it as agency theory (Astami, Rusmin, Hartadi, & Evans, 2017). In order to convince the shareholders so they could received more credits and incentives, the managers tend to manipulate the earnings when the financial statements do not look really good. This kind of action called earnings management.

That's why public companies are required by the Financial Services Authority to publish their financial statements in public annually (Christiani & Nugrahanti, 2014). It is because shareholders have the right to know the performance of the company they are modifying; this also applies to creditors who lend their funds to the company to find out the company's performance. So, it can be said that a reliable financial report is needed, because it can be used as a tool for consideration of an economic decision.

Financial statements that are issued by management within a company will still be considered insecure if they have not been examined by an independent party. Therefore, every publicly listed company is required to audit its financial statements first before publishing them publicly. Auditing is an activity of re-

examining its financial statements and gathering evidence that shows if the financial statements presented are reasonable enough at times, and must be carried out by an independent external party of the company. But of course even with the existence of auditing, it still cannot be avoided from fraud committed by management. Management knows that earnings information is an important information for the basis of decision making, because corporate profits reflect how good a company's performance is, so they often use earnings information as an engineering target where management maximizes its interests, which can harm investors and creditors. The behavior of manipulating corporate earnings, as management desired is known as earnings management (Ebrahim Nawaiseh, 2016).

Earnings management arises because of the agency problems which have a misalignment of interests between managers and owners or shareholders due to imbalance in the acquisition of information where management has more information compared to external parties (Jouber & Fakhfakh, 2011). This situation is usually called as information asymmetry. Hence, external auditor is needed in order to reduce the agency problems or information asymmetry, but each auditor has different qualities in the examination of financial statements. High-quality auditing plays an important role in preventing earnings management, because the reputation of management will be bad and the value of the company will decline if any fraud is revealed.

So the author concludes that the importance of presenting the financial statements correctly makes the auditor very instrumental in the examination. So the author is interested in reexamining the combination of Albersmann & Hohenfels (2017) and Yasser & Soliman (2018) research on "Analysis the Effects of Audit Quality and Audit Committees on Earnings Management" in public companies listed on the IDX. Author chose to study publicly listed companies on the IDX, because their financial statements are easier to obtain and large companies have a greater impact on the economy in Indonesia.

## 1.2 Research Urgency

Herusetya (2009) stated that the reason of investors ask for audited financial statements is because they are going to use it when they have to make an investment decisions. That's why, having a good quality of financial statements is important, financial statements with no earnings management practice can increase the company credible. Earnings management is one of the frauds that is committed by management to flatten, increase and decrease profits for personal gain. The company need an independent outsider such as public auditors and audit committees as well to examine their financial statement, so the company need to prove their integrity of whether the financial statements presented fraud free or not by using external auditors.

In September 2018, there was the case of PT Sunprima Nusantara Financing (SNP Finance) which is part of Colombia, a store that purchases goods on credit, focusing on electronics, furniture, and gadgets. SNP Finance is also involved in other funding activities such as franchising, restaurants and corporate employee financing. This group has been running for about eighteen years. In its activities, SNP Finance obtained financing support for purchases of goods from bank credit. SNP Finance is suspected of falsifying documents, embezzlement, fraud and money laundering where it issues fictitious receivables as collateral for borrowing money. Which caused total losses for a several banks, such as PT Bank Central Asia Tbk (BCA), PT Bank Pan Indonesia Tbk and eleven other banks amounting to fourteen trillion rupiah, for Bank Mandiri there was one point two trillion rupiahs. The auditors who are responsible for checking the financial statements is Satrio Bing Eny & Partners which is the affiliates of Deloitte Touhe Tohmatsu in Indonesia, AP Merliyana Syamsul and AP Marlinna. AP Merliyana Syamsul and AP Marlinna were also restricted from providing audit services to financial service entities for twelve months starting from 16 September 2018 to 15 September 2019; then there are five directors and managers of PT SNP Finance secured by the authorities, as well as other penalties. In addition to SNP Finance, there are also several companies that manage earnings such as PT. Kimia Farma Tbk. in 2001, Bank Lippo Tbk. in 2002, Bank Syariah in 2012.

From the case the author can conclude that auditors who have high audit quality, has a higher possibility to avoid management fraud (Ahmad, Suhara, & Ilyas, 2016; Alves, 2013; Astami, Rusmin, Hartadi, & Evans, 2017; Chen, Chen, Lobo, & Wang, 2011; Dang, Hoang, & Tran, 2017; Gerayli, Yanesari, & Maatoofi, 2011). Conversely, if the auditor has a relatively low audit quality, then the possibility for management fraud will be higher.

### **1.3 Research Questions**

Based on the background that has been explained before, the problem to be investigated will be formulated in the following questions.

1. Does the auditor size have a negative effect on earnings management?
2. Does the auditor's tenure have a negative effect on earnings management?
3. Does the audit committee size have a positive effect on earnings management?
4. Does the audit committee that has expertise in accounting have a negative effect on earnings management?
5. Does the frequency of audit committee meetings have a positive effect on earnings management?
6. Does audit quality and audit committee affect simultaneously on earnings management?

### **1.4 Purposes and Benefits of the Study**

Based on the previous research issues, the purposes and benefits of the study are as follows:

#### **1.4.1 Purposes of the Study**

This research was examined to:

1. Understand the effect of auditor size on discretionary accruals as earnings management proxy.
2. Understand the effect of auditor tenure on on discretionary accruals as earnings management proxy.

3. Understand the effect of audit committee size on discretionary accruals as earnings management proxy.
4. Understand the effect of audit committee competencies on discretionary accruals as earnings management proxy.
5. Understand the effect of the audit committee meetings on discretionary accruals as earnings management proxy.
6. Understand the effect of audit quality and audit committee on discretionary accruals as earnings management proxy.

#### **1.4.2 Research Benefits**

The results of this study can benefit:

1. **For External Parties**  
The author expects the result of this study can be used by external parties such as investors, creditors and shareholders; as a reference to be more careful in investing / giving funds to a company, because there are companies that commit fraud in the presentation of profits that can trick investors in order to make profits.
2. **For Auditors**  
Auditors also be able to use this study as a reference so they can continue to improve the audit quality for financial statements users.
3. **For Companies**  
This research is intended to contribute the awareness about earnings management so that the managers will understand and avoid it in financial statements.
4. **For Readers**  
From this research, the author expects it will increase the readers' knowledge and convey information about audit quality, audit committee and earnings management.

#### **1.5 Research Systematics**

There are five chapters used for systematic research, which consists of the following:

**CHAPTER I INTRODUCTION**

Description of the problem's background, research issues, the purposes and benefits of research and research systematic are contained in this section.

**CHAPTER II LITERATURE REVIEW**

In this section, the author will describe the theoretical basis that is used for research references, the definition of earnings management, previous research model related to research, factors affecting earnings management, included hypothesis and research framework.

**CHAPTER III RESEARCH METHOD**

Chapter III contains an explanation of the research variables and their operational definitions, populations and samples, types and sources of data, methods used to collect data, and analytical methods used in this study.

**CHAPTER IV ANALYSIS AND DISCUSSION**

Results and analysis that describe the research objects, data analysis, and the interpretation are discussed in this chapter.

**CHAPTER V CONCLUSION AND SUGGESTIONS**

This section discusses about the result conclusions of the research, study limitations and suggestions for future research findings.