CHAPTER I

INTRODUCTION

1.1 Background

Earnings management has become one of the critical issues in the contemporary business world. Especially because of its significant impact on the transparency of financial statements. This phenomenon is often triggered by pressure from shareholders, the need to fulfil market expectations, and compensation incentives for management. In any perspective, earnings are an essential performance indicator for a business. Earnings serve as a vital performance indicator for companies. They reflect not just the present financial condition of a business but also its future outlook. The earnings report is the report that is most frequently examined and questioned. It also consistently attracts investor interest (Kothari, 2001). A report of robust earnings can lead to a dramatic increase in a company's stock price. Conversely, a report of poor earnings can lead to a significant drop in a company's stock price.

Financial statements provide information about the performance of a company and show the company's earning or income (Tang and Shandy, 2021). The company uses this earnings information as a basis to determine its dividend policy, calculate its fiscal liabilities, make investment and corporate management decisions, and forecast future company growth (Belkoui, 2006). Investors use reported earnings in financial statements as a key metric to evaluate the potential risks and return characteristics of capital investments. Earnings information is the criterion by which management performance is evaluated and compensation is paid

(Kjærland et al., 2020). Singh et al. (2016) emphasized that analysts, investors, and regulators are concerned with the accuracy of financial statements. Therefore, earnings information should be presented in compliance with applicable accounting standards and fulfil accounting principles that are consistent, objective, relevant, and reliable.

As a result, businesses should provide clear financial reports so that shareholders and stakeholders may keep an eye on the company's performance and decide what investments to make. Making significant earnings can help a business become more credible in investors perspective, boost shareholder confidence, and improve relations with creditors (Taco and Ilat, 2016). High-earning businesses will attract investors to put their money there (Hung, Linh, Hoa, Dung, and Ha, 2018). The pursuit of substantial earnings drives earnings management, because the value of businesses is seen from how they get maximum earnings in the financial statements.

Earnings management is the process by which management alters the firm's financial statements to influence corporate earnings, either up or down, or even remain the same (Astari and Suryanawa, 2017). This practice often prioritizes short-term financial appearances over the long-term goal of maximizing shareholder returns. It potentially compromising the integrity and transparency of financial reporting. By engaging in earnings management, companies may present a distorted view of their financial health. It can mislead investors and other stakeholders who rely on accurate financial information for making informed investment decisions. This manipulation can lead to a decline in investor confidence, as stakeholders become wary of the reliability and quality of the reported financial results.

Consequently, the perceived usefulness of financial statements for investment decisions diminishes. The fundamental purpose of financial reporting, which is to provide transparent and relevant information to shareholders and the market is corrupted.

The corporation, its stakeholders, and the economy as a whole may severely harmed as a result of unethical actions earnings management that are occasionally brought on by the chase of large earnings. The 2000s witnessed a series of major accounting scandals in the US that sent shockwaves through the economy, eroding investor confidence, and prompting significant regulatory reforms. One of the most notorious scandals was the Enron scandal, which led to the collapse of energy giant Enron Corporation and the subsequent indictment and conviction of its CEO, Jeffrey Skilling, and CFO, Andrew Fastow. The scandal involved the use of complex financial structures to conceal billions of dollars in debt and inflate Enron's financial performance. Ultimately, this led to the loss of thousands of jobs and billions of dollars in investor losses.

In Indonesia, there was several fairly shocking earning management scandal. One of them is a scandal involving allegations of financial statement manipulation and corruption involving PT Garuda Indonesia Tbk. in 2020. Allegations surfaced that the national airline paid far more than market value for an Airbus A330-900neo aircraft. Furthermore, there were disagreements over Garuda's financial statements because of purportedly imprecise inflation of income and expenses, which might have deceived investors. To find out more about the harmful activities, the Financial Services Authority (OJK) and the Corruption Eradication Commission (KPK) launched an inquiry. Garuda's reputation and stock price suffered as a result of this controversy, demonstrating the significance of openness and sound governance in averting future occurrences of this kind.

And most recently, a case of profit manipulation by a subsidiary of PT Kimia Farma Tbk (KAEF) was revealed. Around 2021-2022 Kimia Farma Apotek (KFA) a subsidiary of KAEF is suspected of violating the integrity of providing financial statement data. An internal audit conducted by KAEF found alleged violations that caused losses of around IDR 1.82 trillion in 2023. This violation also affected the decline in KAEF's profit in 2023. Kimia Farma's management together with the Ministry of SOEs and PT Bio Farma (Persero) are conducting internal improvements to address this issue. The alleged manipulation involved an increase in the value of distribution and sales that did not match reality, as well as a significant increase in operating expenses in 2023. This affected revenue, COGS, and operating expenses, which then contributed significantly to the loss in 2023.

With major scandals like Enron, the world has finally realized the importance of corporate governance (CG). CG is concerned with the relationships of managers, boards of directors, employees, shareholders, and other stakeholders. Kaihatu (2006) states that the essence of CG is to enhance company performance by supervising or monitoring management performance and accountability of other stakeholders. In the context of CG, board of directors has a central role. The board of directors has a huge responsibility as it seeks to maintain accountability and challenge. The board of directors must not only stop negative management actions that could lead to scandal or corporate failure, but also ensure that the company takes action on opportunities that enhance the value and wealth of all stakeholders.

Businesses need board of directors in order to limit or restrict inappropriate activities in earnings management. The board of directors plays an important role in terms of supervision of management performance and the quality of financial statement information (Mardianto and Chintia, 2022). The board of directors is responsible for all decisions made by company management. Whether the decisions taken maximise wealth for shareholders or result in damage to the company's reputation (Kapoor and Goel, 2017). The board of directors also making strategic corporate decisions that are aligned with the best interests of shareholders and ensuring management acts in accordance with those strategies. A board of directors that works efficiently and well will result in positive company earnings.

One of the most critical components in a corporate organisation is the board of directors. Especially in light of the wave of corporate resentment and disillusionment that several leading companies around the world have experienced (Azeez et al., 2019). Stakeholders are increasingly recognising that the composition, diversity, and independence of a board of directors can significantly impact a company's performance and reputation. This makes the topic of board characteristics one of the most discussed topics on a global scale (Azeez et al., 2019). A well-structured board, equipped with members who have diverse skills and experience, can improve the quality of oversight and foster a culture of accountability within the organisation (Dokas, 2022).

Board characteristics refer to the attributes and qualities that define the composition, structure, and functioning of a board of directors within an organization. These characteristics can significantly influence the effectiveness of the board in overseeing management, making strategic decisions, and ensuring accountability. Key characteristics include board independence, board diversity, professional background, and board expertise and experience. Board size, time commitment and allocation, and a strong leadership structure are also important elements of a board of directors. Collectively, these characteristics contribute to a well-functioning board that oversees management effectively, directs strategy, and safeguards.

Numerous research has been done to study the relationship between board characteristics and earnings management. Bangun and Cristian (2021) argued that board size has significant positive effect on earnings management, meanwhile board gender diversity, board meetings, and profitability have insignificant effect on earnings management. Fitrasari (2023) supports the argument that a large board size is an ineffective tool for reducing earnings management. It means board size has insignificant effect on accrual and real earnings management. This research also found that larger board independence has a negative effect on accrual and real earnings management.

According to El-Din (2021) there is no correlation between the number of board meetings and board size and earnings management in the Egyptian context. This suggests that these two board characteristics have no effect on earnings management. Khan et al. (2022) research showed that directors independence and directors financial expertise play an important role in mitigating earnings manipulation (discretionary accruals) after the introduction of Code of Corporate Governance 2017 (CCG-2017). Furthermore, Githaiga et al. (2022) showed that board size has a significant influence on earnings management. On the other hand, there is a negative correlation between board independence, gender diversity, and financial expertise and earnings management.

Despite the fact that numerous studies have examined the relationship between board characteristics and earnings management. Most of the studies are still focused on developed countries. Only a few studies have examined this dynamic in the context of developing countries, especially the Southeast Asian region. Indonesia is one of the developing countries in Southeast Asia. Indonesia has unique characteristics in corporate governance structure and earnings management practices. Therefore, this study attempts to provide a deeper understanding of how board characteristics can influence earnings management in a different setting from previous studies by considering the dynamics of the Indonesian market, cultural variables, and laws and regulations.

Based on the description above, this study will empirically test **The Effect of Board of Director Characteristics on Earnings Management (study of companies listed on the Indonesia Stock Exchange in 2021-2023)**. Board characteristics will be proxied by four variables, namely board size, board independence, board financial expertise, and board gender diversity. This is because these four board characteristics have an influence on the decision-making process within the board of directors. The size of the board of directors can influence the dynamics of discussion and decision-making, while the independence of board members is crucial to ensure that decisions taken are not influenced by personal interests. The financial knowledge of board members is also important to understand the financial statements and risks faced by the company. In addition, gender diversity in the board of directors can provide a broader perspective and improve the quality of decision-making.

The period 2021-2023 was chosen as the focus of this study because it reflects the latest economic and regulatory conditions that may affect the relationship between board of directors and earnings management. In addition, it is a crucial period in the post-pandemic recovery phase, where companies face significant financial and operational challenges. During this period, many companies had to adjust their financial strategies, including potential earnings management practices, to maintain investor confidence and financial stability. In addition, regulatory developments in Indonesia, such as the increased emphasis on corporate governance practices by the Financial Services Authority (OJK), make this period particularly relevant to examine the role of board characteristics in influencing earnings management.

In addition, for last few years in Indonesia the scrutiny of corporate governance practices has intensified, especially after the revelation of various financial scandals and earnings manipulation in public companies. Financial misstatement cases in various sectors point to weaknesses in board oversight mechanisms, raising concerns about the effectiveness of corporate governance. In addition, the increasing drive to increase gender diversity in leadership, both through regulation and pressure from investors, further fuels the need for research on its influence on corporate financial decisions, including in earnings management practices.

With earnings management as the dependent variable calculated by discretionary accruals and using performance measured discretionary accruals model (Kothari et al., 2005). Previous literature recommended that the performance measured DA model is effective and provides strong earnings management tests compared with the Jones Model and the modified Jones Model (Usman et al., 2022). This study uses four control variables, namely firm size, return on assets, leverage, and BIG 4 auditor office (Vadasi and Polyzos, 2023).

1.2 Problem Formulation

Based on the background described above, the problem formulations in this study are as follows:

1. Is there a negative relationship between board size and earnings management in companies on the IDX?
2. Is there a negative relationship between board independence and earnings management in companies on the IDX?
3. Is there a negative relationship between board financial expertise and earnings management in companies on the IDX?
4. Is there a negative relationship between board gender diversity and earnings management in companies on the IDX?

1.3 Research Objective

The purpose of this research is to:

1. To investigate the effect of board size on earnings management in companies on the IDX.

2. To investigate the effect of board independence on earnings management in companies on the IDX.
3. To investigate the effect of board financial expertise on earnings management in companies on the IDX.
4. To investigate the effect of board gender diversity on earnings management in companies on the IDX.

1.4 Research Benefit

The results of this study are expected to benefit various parties, especially the government (regulators), companies, investors, and academics.

1. For regulators, the results of this study are able to identify corporate governance variables (board of director) in order to make rules that help prevent earnings management. The government must ensure strict compliance with applicable corporate governance rules.
2. For companies, the results of this study can be one of the insights in ensuring and determining the formulation of corporate governance elements in the company.
3. For investors, the results of this study can be taken into consideration in responding to information published by companies, especially earnings. Investors can consider more information related to earnings in their decision making.
4. For academics, the findings of this study will enrich the literature on corporate governance, especially in the context of developing countries such

as Indonesia, by providing new insights into how board characteristics affect earnings management practices.

1.5 Writing Systematic

The writing systematic in this research consists of five chapters. The first chapter presents an introduction that discusses the background of the problem, problem formulation, research objectives, research benefits and writing systematics. Furthermore, the second chapter explains the literature review which contains the literature used as a theoretical basis, review literature and hypothesis development, and conceptual framework. Then, the third chapter contains research methods consisting of research design, population, samples, types and sources of data, research variables along with data analysis methods. Then, the fourth chapter presents the results of the study which contains data analysis and discussion of the results of hypothesis test. Finally, the fifth chapter contains conclusions, implication, limitation, and suggestions for future researchers.