CHAPTER I
INTRODUCTION

1.1 Background of Study

Financial statements are means of communicating financial information to the interested parties, both internal and external users. The financial statements contain a summary of recording financial transactions that occurred during the financial year. Information in financial statements is one of the benchmarks of a company's financial condition, to provide the information related to the company's financial position, performance, and cash flow to users in order to make economic decisions as well as demonstrate management accountability for the use of resources (Alhalik, 2015). One of the elements in financial statements that can attract users is earnings generated by the company. The higher the company's earnings, the more users will think that it is worth investing in. Therefore, the managers want to increase the earnings reported in financial statements to shareholders and other external users (Rahmi, 2013).

In preparing financial statements, managers use the accruals basis because it is considered more rational and fair in reflecting its financial condition. Accrual basis has the advantage that it can provide a better indication of the company's performance than information from the aspect of current cash receipts and payments. However, the use of accrual basis also has weaknesses. It provides flexibility to management in choosing the accounting method, allowing the managers to commit fraud. If the company cannot reach the investor's targets, the managers often conduct earnings management practices to generate the desired earnings. Earnings management is a practice that involves deliberate manipulation of financial statements within limits allowed by prevailing common principles, thus potentially providing misleading information to users of financial statements for the manager's benefit (Alexander & Hengky, 2017)

This management practice causes the disclosure of earnings information to be misleading, affecting decision-making errors by interested parties, especially investors who obtain inaccurate information. Earnings as a part of the income statement no longer present a real company's economic condition. The quality of the earnings that was initially expected to provide information to support decision-making becomes doubtful. Earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial reports to mislead some stakeholders about their performance or influence contractual outcomes that depend on reported accounting numbers (Ronen & Yaari, 2008). Efforts to manipulate information through earnings management practices have become a significant factor causing financial statements to no longer reflect a company's fundamental value. The phenomena of earnings management have led to several cases of accounting reporting scandals that are widely known, including Enron, Merck, WorldCom, and the majority of other companies in the United States (Cornet et al., 2006). Earnings management is like never-ending cases that can happen worldwide, including in Indonesia. Several cases occurred in Indonesian companies, such as PT Lippo Tbk, PT Bank Bukopin Tbk, and PT Kimia Farma Tbk were also involved in fraudulent financial reporting that originated from the detection of earnings management.

Some parties view earnings management from two different perspectives. The first is earnings management as an act of fraud. Earnings management is a fraud because managers' opportunistic behavior to play with the numbers in the financial statements under the goals they want to achieve. This practice is deliberately to gain the unilateral advantage. Meanwhile, the second, earnings management is not a fraud because it impacts the manager's flexibility to choose the accounting methods used in recording and preparing financial information deemed appropriate for the company (Sulistyanto, 2014)

Many factors affect earnings management practices within a company. Several factors that influence earnings management are accounting conservatism, tax avoidance, firm size, leverage, and institutional ownership. Previous research on the factors that might affect earnings management has resulted in inconsistent results, thus creating a research gap. Extant research report mixed results, Gao, (2013), Haque et al., (2016), and Li (2018) report a negative association between accounting conservatism and earnings management. In contrast, Mashoka (2018) find a positive association between conservatism and earnings management and Abed et al., (2012) report that conservatism affects earnings management. Larastomo et al., (2016) and Subagiastra et al., 2017) found that tax avoidance affects earnings management. However, Wardani & Santi (2018) found that tax avoidance did not affect earnings management because taxation's responsibility may be separable to another division. Alexander & Hengky (2017) stated that firm size and leverage do not affect earnings management. In contrast with Dang et al., (2017) stated that firm size has a positive relationship with earnings management and Widyastuti (2009) found that leverage motivates company managers in carrying out earnings management.

This study used the population and sample from the Indonesian Stock Exchange company and included in the LQ 45 index. LQ 45 refers to the index that measures the price performance of the top 45 stocks that have high liquidity and large market capitalization among various industries. Companies included in this index are also screened as companies with growth prospects and good financial conditions. Thus, it is the reason for the researcher to select the population and sample in the study. It is exciting to know whether companies with good fundamentals indicate practicing earnings management. Previous research has focused on the companies in specific industries, which is only a few generate stable and growing financial performance. Thus, the significant result regarding the earnings management factors being tested majority resulted from the average to bottom level companies within the industry.

Based on the background described above, the researcher is interested in researching **"Influencing Factors on Earnings Management Empirical**

Evidence from Listed Indonesian Companies Included in LQ 45 Index", which provides more evidence of earnings management factors also clarifies the research gap from previous studies.

1.2 Research Questions

Based on the background described above, the problem formulations that will be discussed in this research are:

1. Does accounting conservatism influence earnings management?
2. Does tax avoidance influence earnings management?
3. Does firm size influence earnings management?
4. Does leverage influence earnings management?
5. Does industrial type influence earnings management?
6. Does institutional ownership influence earnings management?

1.3 Research Objectives

This research aims to obtain empirical evidence about the influence of accounting conservatism, tax avoidance, firm size, leverage, industrial type, and institutional ownership on earnings management.

1.4 Research Benefits

This research is expected to provide benefits in the form of:

a) For the researcher

These research results are expected to provide insight and knowledge and be able to empirically prove the influence of accounting conservatism, tax avoidance, firm size, leverage, industrial type, and institutional ownership on earnings management.

b) For the company

These research results are expected to be referenced and additional information for interested parties in decision-making and related policymakers.

c) For the business practitioner

These research results are expected to be input in investment decision-making to assess the company's quality of earnings.

d) For academics

This study's results can be used as literature or reference to conduct further research or add information about factors affecting earnings management practices.

1.5 The Scope of Research

This research analyzes the factors that influence the earnings management in listed companies in the Indonesian Stock Exchange (IDX) included in the LQ 45 index. The data collected from 2017 to 2019. This study focused on accounting conservatism, tax avoidance, firm size, leverage, industrial type, and institutional ownership as factors that may affect earnings management.

1.6 Writing Systematic

CHAPTER I: INTRODUCTION

This chapter explains the background of the problem to be researched, the formulation of the problem, the purpose of the research, the benefits of research, and the writing system.

CHAPTER II: LITERATURE REVIEW

This chapter explains literature reviews related to research topics, previous research, theoretical frameworks, and hypotheses development.

CHAPTER III: RESEARCH METHODS

The research method provides an overview of the plan for conducting the research. This chapter includes the research design, research model, operational definition and research variable, population and sampling, data and data collection method, and analysis method.

CHAPTER IV: RESULT AND DISCUSSION

This chapter outlines data collection results, data analysis, hypothesis testing, and discussion of the results.

CHAPTER V: CONCLUSIONS

Conclusions are drawn from the research results, limitations of this research, and suggestions for further research.