CHAPTER I
INTRODUCTION

1.1 Background of the Study

Corporation is any forms of business entities which have fixed business types, establishing and working continuously in Indonesia, as well as have profit oriented (Kansil, 2001). The corporation's aim is to maximize the wealth and value of the firm itself (Dominick, 2005). Thus, it is crucial for the corporation to hire an expert or professional as Manager to running the corporation innovatively.

The manager must inform any information relating to the corporation's performances in the form of financial statement to the relating parties such as investor. Corporation's performances are frequently measured by incomes or earnings. Wicaksono (2013) revealed that Income components in a financial statement often used as a standard by Principals in measuring company's performances. Stice andSkousen (2009) stated that earnings or income is return on investments to the Principals or owners. Earnings component in financial statement is resulted from accrual method (IAI, 2009). Dechow (1994) stated that income from accruals is a better measurements than cash flow from operational activities.

The manager as an agent has greater information related to the business activity compared to the owner. This condition is widely known as information asymmetry that will potentially lead to the manager's infraction. Furthermore, this condition also cause an interest conflict between the manager and the owner because the Manager tends to give priority to it own interest instead of maximize the owner’s wealth. One of the Agents actions relating to those situations is known as Earnings Management (Widyaningdyah, 2001).

Earnings Management is Managers activity to manipulate the current earnings from one item without associates it with long term economics fluctuations (Fischer dan Rosenzweig, 1995). Furthermore, Earnings Management will lead to financial loss to the interest parties because Earnings Management can manipulate information in the financial report which in turn affects investor decision making.

During the past two decades, earnings management raised serious concerns among financial markets regulators, operators, investors, and academic researchers as a large numbers of international companies are involved in earnings management scandals such as Enron, Tyco, and Xerox. The case is also the same in many of development country such as Indonesia, Earnings Management activity still often practiced in both international and national companies such as PT Kimia Farma Tbk; PT Indofarma Tbk; Great River; PT Agis Tbk; PT Perusahaan Gas Negara Tbk. (PGAS); PT Arona Binasejati; and PT Indomobil Sukses Internasional (Lliukani, 2013).

Various factors are often triggered the earning management. Suriyani *et al* (2015) suggested that Managerial ownership, Audit Committee, leverage, and board of commissioner independent (BOC independent) are the main factors that triggered the earnings management. Elaborate more by Nurdiniah and Herlina

(2015) which found that Earnings Management in many companies frequently affected by Firm Size, Bonus Motivation and Leverage.

Earning management literature has had long history and therefore, had been focusing on various aspects. Suriyani *et al* (2015), Nurdiniah dan Herlina (2015), Nassirzadeh, *et al* (2015), andDilger and Graschitz (2015) observed some factors that influence Earnings Management activities. Ali, et al (2015), Warfield (1995), Barto (2002), and Llukani (2013) analyzed the impacts of Firm Size on Earnings Management activities. While, Patrick *et al* (2015), Gelderen (2013), Chekili (2012) Swastika (2013), Demerjian et al (2012), and Wicaksono (2013) analyzed the impact of GCG and Managerial Ability on Earnings Management.

Those studies had contradictory results. In term of Firm Size, Warfield (1995) classified firm into large firms and small firms.He suggested that large firm has better internal controls which help them to provide credible financial reports compared to the smaller firms.Thus, the large firm has a lower indication to Earnings Management than the small firm. In addition, Ali*et al* (2015) suggested that audit system in large firm usually handled by large audit companies that has a good qualification in auditing. Thus, large firm will not have an opportunity to manipulate earnings. However, Barto (2002) found a contrary result. The large firm inclined with Earnings Management activity than the small firm as a result of pressure from the principle. Different from the others, Llukani (2013) found that both small and large firm has the same possibility on Earnings Management activity.

A Previous study which examines the influence of Managerial Ability on Earnings Management also shows inconsistency. Francis (2006) and Hastuti (2013) revealed that Managerial Ability has no significant effect on Earnings Management. However, Demerjian *et al* (2006) and Wicaksono (2013) found that Managerial Ability significantly affects Earnings Management. In the other word, the more competent a Managers the greater it chances to manipulate earnings.

Forum for Corporate Governance in Indonesia (FCGI, 2001) defines Corporate Governance as a set of rules or regulations that governing relationships between shareholders, Managers, creditors, governments, employees and other internal and external parties, relating to their rights or obligations, or in other words a system that regulates and controls the whole company.

Similar with Isnugrahdi and Kusuma (2009), Wicaksono (2013) observed the impact of Managerial Ability on Earnings Management which moderated by GCG mechanism. However, those two studies found different result. Isnugrahdi and Kusuma (2009) revealed that GCG mechanism have no effect on the relation between Managerial Ability on Earnings Management. However, Wicaksono (2013) found that GCG mechanism able to strengthen relation between Managerial Ability and Earnings Management.

Relating to those gaps and phenomenon, easy to conclude that it is still necessary to gain further research related to Earnings Management practiced in company. This research refers to Swastika (2013) which identified the influence of Firm Size and GCG mechanism on Earnings Management at Indonesia Stock Exchange with the study's object of Food and Beverage Companies during the period of 2005. Along with swastika (2013), this study also uses food and beverage companies as the study's object. However, the research period of this study is span from 2010 to 2015, which is greater from the previous study. This study also put additional variable such as Managerial Ability which is elaborated from the study of Wicaksono (2013) that investigated the influence of managerial ability on earnings management with GCG mechanism as the moderating variable in manufacturing companies during the period of 2009 to 2011. This study also uses Audit Committee and Board of Commissioner independent (BOC independent) as the proxy of Good Corporate Governance mechanism, while Managerial Ability uses Data Envelopment Analysis (DEA) as its proxy (Demerjian *et al*, 2006). Relating to those backgrounds, the writer want to conduct research entitled "**The Influence of Firm Size and Managerial Ability on Earnings Management with GCG Mechanism as Moderating Variable**"

1.2 Problem Statement

According to those backgrounds above, statement of problems in this studya re formulated as follows:

1) How significant the influence of Firm Size on Earnings Management practice in a company?
2) How significant the influence of Managerial Ability on Earnings Management practice in a company?

3) How significant the Board of Commissioner independent (BOC independent) in influencing the relationship between Firm Size and Earnings Management practice in a company?
4) How significant the Board of Commissioner independent (BOC independent)in influencing the relationship between Managerial Ability and Earnings Management practice in a company?
5) How significant Audit Committee in influencing the relationship between Firm Size and Earnings Management practice in a company?
6) How significant the influence of Audit Committee on the relationship between Managerial Ability and Earnings Management practice in a company?

1.3 Objective of the study

Relating to the statement of problems above, the objective study can be described as follows:

1) To analyze the Influence of Firm Size on Earnings Management practice.
2) To analyze the Influence of Managerial Ability on Earnings Management practice in company.
3) To analyze the Influence of board of commissioner independent (BOC independent) on the relationship between Firm Size and Earnings Management.
4) To analyze the Influence of board of commissioner independent (BOC independent) on the relationship between Managerial Ability on Earnings Management practice in company.

5) To analyze the Influence of Audit Committee on the relationship between Firm Size and Earnings Management practice.
6) To analyze the Influence of Audit Committee on the relationship between Managerial Ability and Earnings Management.

1.4 Significant of the Study

It is expected that the result of this study will be used as additional information for the following user:

1) Academician

   It is expected that this study will provide information and contribute significantly to the knowledge development in accounting and management, particularly relating to Earnings Management.

2) Future research

   It is expected that this study will contribute as a reference for future research especially related to Firm Size, Managerial Ability, GCG, and Earnings Management.