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CHAPTER 1

INTRODUCTION

1.1 Research Background

Firm's performance is reflected by the stated amount of earnings in the financial reports. In general, when the stated amount of earnings is high, the firm will be considered as a firm with good performance, but when the stated amount of earnings is low, the firm will be considered as a firm with bad performance. To avoid bad assumptions and many other motivations, managers may conduct earnings management in order to manipulate the amount of reported earnings. Scott (2012) defines earnings management as the choice by a manager of accounting policies, or real actions, affecting earnings so as to achieve some specific reported earnings objective. It means that the managers have a freedom to choose what accounting policy used for the firm in order to achieve their purposes.

A serious agency problem may lead the managers conduct the practice of earnings manipulation among companies nowadays (Healy & Wahlen, 1999). From earnings fraud to earnings management are the kinds of earnings manipulation. Earnings fraud is conducted by the firm to deceive financial statements users by reports the financial statements that contain intentional misstatements or omission of amounts or disclosures (Malaysian Institute of Accountants, 2002). Earnings management may involve manipulation of accounting records, intentional omission or intentional misapplication of accounting principles (Aini, 2006). Earnings management occurs when managers

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use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers (Healy & Wahlen, 1999).

According to Meta (2011), to detect the existence of earnings management, so far only *aggregate accruals-based models* generally accepted as a model that gives the most accurate results in detecting earnings management. Aggregate accruals-based model used is the Modified Jones Model. This model developed by Dechow, et al. (1995). Component of total accruals in the Modified Jones Model can be separated into two, namely discretionary accruals and non-discretionary accruals.

The discretionary accruals is a accruals component derived from managerial modified by utilizing the freedom and flexibility in determining the estimated value of accounting method. For example, freedom in determining estimated residual value of the depreciation of fixed assets and the estimated percentage value for doubtful accounts. Meanwhile, the non-discretionary accruals is a component of total accruals that naturally derived from the accounting records by following accounting standards that generally accepted (Sulistyanto, 2008).

The reasons for earnings management are diverse and range from the intention to satisfy analysts' expectations, to incentives, to realize bonuses, or to maintain a competitive position within the financial market. Legal earnings management means financial reports are adjusted in line with financial reporting standards. Earnings management becomes fraudulent financial reporting when it

falls outside the bounds of financial reporting standards. Therefore, firms will may engage in earnings management when the benefits of this behavior are higher than the risks and costs involved.

Based on Scott (2012), manager may engage in earnings management for a variety reasons. First, *bonus purposes*, for getting higher bonus. Second, *debt covenant*. to fulfill the obligation of debt covenant. Third, *political motivation,* to get facilities and easiness from the government. Fourth, *taxation motivation,* to minimize tax payment. Fifth, *CEO (Chief Executive Officer) replacement,* to get higher bonus before being retired. Sixth, *Initial Public Offering,* to increase the firm value.

Firm size is a measurement to classify the size of the firm under a variety of ways, such as total assets, log size, value of the stock market, and others. Basically, according to Suwito and Herawaty (2005: 138) the size of the firm is only divided into 3 categories, namely large firm, medium firm, and small firm. They determine the size of the firm based on the total assets of the firm. The firm size will affect the financing structure of the firm. In general, large firms tend to require larger funding than smaller firms. Usually, additional funds can be obtained from the issuance of new shares or incurrence of liabilities. Motivation to get these funds may encourage the management to conduct earnings management practices, because when high profit reported, the potential investors and creditors will be interested to invest their funds to the firm.

Research conducted by Handayani and Rachadi (2009) stated that all firm sizes tend to conduct earnings management. But, Siregar and Utama (2005) stated firm size has negative effect on earnings management, means the larger firm size,

the lower indication earnings management and the smaller firm size, the higher indication of earnings management.

Free cash flow is a firm's operating cashflow after investment in new capital but before considering new debt. Copeland, et al. (1996) define free cashflow in the following way:

> "Free cash flow (FCF) is a company's true operating cash flow. It is the after-tax cash flow generated by the company and available to all providers of the company's capital, both creditors and shareholders. It can be thought of as the after-tax cash flows that would be available to the company's shareholders if the company had no debt."

Firm's operation value depends on the amount of free cash flow expected in the future. Free cash flow will be relevant when it is used to estimate the value of a firm. Therefore, managers often increase the amount of their free cash flow to make their firm has a higher value.

White *et al.* (2003:68) stated that the greater free cash flow available in a company, the more healthy the company because it has available cash for growth, debt payments, and dividend payments. It also can be said that the smaller free cash flow amount of the company, the more unhealthy the company. But, Agustia (2013) and Isnawati (2011) found a negative effect of free cash flow on earnings management.

Financial leverage describes the source of funds from operating activity used by the firm. The financial leverage also shows risks faced by the company. The greater the risk, the more uncertainty earnings obtained by the firm in the future. Foster (1986: 65) reveals that there is a relationship between firm leverage ratio and the return. This statement means that debt can be used to predict the earnings that might be obtained by the firm for the investor. DeAngelo et al.

(1994) and Fraser and Ormiston (2004: 185) measures the financial leverage by divided Total Liabilities with Total Assets.

The relationship between leverage ratio and earnings management that related to agency theory was stated by Watts and Zimmerman (1986). They stated that in agency theory, the closer the company to accounting-based debt covenant violations, more likely managers to choose accounting procedures that can move reported earnings from future period to the current period.

Research conducted by Widyaningdyah (2001) found that financial leverage has positive significant effect on earnings management. That result similar to research conducted by Naftalia and Marsono (2013) that stated the higher leverage, the higher earnings management indication. Similarly, research conducted by Agustia (2013) stated the company with a higher proportion of debt than the proportion of assets will tend to perform earnings management. The different findings found by a research conducted by Nasser and Parulian (2006), which is leverage does not significantly influence the practice of earnings management.

Effendi (2009:2) defined Good Corporate Governance (GCG) as a set of systems that regulate and control the firm to create value added for stakeholders, because GCG can encourage the creation of honest, transparent, and professional management. So, good corporate governance is an important thing to attract the investors as the firm need the funding support, especially for competitive firms to gain strong position in facing their competitors. Good corporate governance can be achieved in the organization by maintain a good relationship between the owner of the firm and manager, also among the interests of stakeholders of the

firm. If good corporate governance successfully implemented, it might be helpful in reducing the agency problems of the firm. Komite Nasional Kebijakan Corporate Governance or is called by KNKG (2006) also stated five principles that should be exist in order to implement good corporate governance. Those principles are transparancy, accountability, responsibility, independency, and fairness.

Implementation of good corporate governance in the firms may impact the earnings management practice conducted by the manager. Good corporate governance implementation also may function as a mechanism for monitoring and controlling the activities performed by the management, because good corporate governance might be able to limit the actions of managers in managing earnings, so it's presence in the firm should be able to minimize the actions of managers to manipulate or adjust earnings.

By looking the explanation above the researcher intends to investigate, whether the implementation of good corporate governance in the firms able to moderate the effect of firm size, free cash flow, and financial leverage on earnings management or not. As explained above, good corporate governance is the most important thing that affects behavior of a firm, no matter how large that firm. So, the researcher uses good corporate governance as moderating variable. Good corporate governance on this research is measured by CGPI (Corporate Governance Performance Index) that conducted by IICG (The Indonesian Institute for Corporate Governance). Gendut (2008) defined CGPI as a program in researching and rating the implementation of GCG on Indonesian firms. CGPI is used by Public Firms, BUMN, Banks, and others.

Firms that following CGPI assessment and listed on the BEI have been chosen by the researcher for being the research object by considering the following reasons: First, the availability of audited financial statements for public. Second, there is a regulation that requires all companies listed on the BEI to be audited by an independent auditor. Third, valid and sufficient information about GCG score.

Refer to the background above, the researcher will conduct a research entitled "The Effect of Firm Size, Free Cash Flow, and Financial Leverage on Earnings Management with Good Corporate Governance as Moderating Variable for Non-financial Firms in CGPI Survey from 2009 to 2013".

1.2 Research Problems

Based on research background, there are two problems discussed in this research:

1. Do firm size, free cash flow, and financial leverage have effect on earnings management?
2. Does good corporate governance have effect on the relationship among firm size, free cash flow, financial leverage and earnings management?

1.3 Research Objectives

The objectives of this research are:

1. To investigate whether firm size, free cash flow, and financial leverage have effect on earnings management or not.

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2. To investigate whether good corporate governance is able to moderates the relationship among firm size, free cash flow, financial leverage and earnings management or not.

1.4 Research Contributions

This research is expected to generate useful things, in terms of theory of for the writer related with the problem researched. The contributions of this research are as follow:

1. Empirical Contribution
   a. Applied the existing theory and give new insight about the effect of firm size, free cash flow, and financial leverage on earnings management with corporate government as the moderating variable.
   b. This research findings are expected to become reference in conducting future research.
2. In Practice Contribution

   This research findings are expected to give some suggestions for management in evaluating good corporate governance, firm size, free cash flow, financial leverage, and earnings management, also for investors, to not only see the good corporate governance score in trusting the firm, but also see the others factor.

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1.5 Research Systematic

This research is consisted of five chapters, among which chapters are related each others. Those chapters are arranged as follow:

Chapter One: Introduction

Chapter one explains the background that motivate the researcher to conduct this research. This chapter explains earnings management and its relation with firm size, free cash flow, and financial leverage, whether directly or moderated by good corporate governance (CGPI). Also brief explanation about inconsistency findings resulted by previous research that motivate the researcher to conduct this research.

Chapter Two: Literature Review

Chapter two delivers theories related to earnings management, firm size, free cash flow, financial leverage, and good corporate governance. Agency theory and signaling theory are grand theory to explain the relationship or effect of firm size, free cash flow, and financial leverage on earnings management, whether directly or moderated by good corporate governance (CGPI). This chapter also delivers previous researches, conceptual framework, and hypotheses development.

Chapter Three: Research Methodology

Chapter three delivers research approach, which is quantitative, followed by variables operational definition and measurement, data type and source, data collection method, population and sample, data analysis technique, and research limitation.

Chapter Four: Results and Discussion

Chapter four describes research object, descriptive data statistic to depict observations characteristic, result of analysis model, hypotheses testing, and ended by result discussion.

Chapter Five: Conclusion and Suggestion

Chapter five delivers conclusion of this research, and suggestions for upcoming research.