# CHAPTER 1

# INTRODUCTION

## 1.1 Background of the Study

Financial report is a company's financial information in the accounting period that describes the performance of the company. Information provided and needed by users are related to the liquidity, solvency, and profitability of banks. The essential information to reconsidered by users of financial report is profit, because it represents important information of banks, such as performance appraisal and performance of banks, guidelines for investment policy, and basic forecasting earnings in the future (Syahfandi, 2012:1).

The importance of profit encourages to conduct managers for earnings management and cause management to manage earnings in an attempt to make the entities look good (Syahfandi, 2012:2). Earnings management practice is a deliberate act of managers to manipulate financial reports within the limits permitted by accounting principles in order to provide misleading information to users of financial report in the interest of the manager (Muetia, 2004 in Kartikasari, 2011:1).

The earnings management practices occurs when management uses certain decisions in the financial report and transactions to alter financial report as the basis for the company's performance. This practice can mislead owners or shareholders, and can also influence the contractual result which rely accounting figures reported (Healy and Wahlen, 1998 in Siswantaya, 2007:1). There is earnings management practices because managers were given freedom to choose the accounting method in recording and disclosing the financial information. Besides manipulating, there is earning management practices because of the information asymmetry is high between management and others who have not the resources, encouragement, or adequate access to information to monitor the actions of managers (Richardson, 1998 in Siswantaya, 2007:2).

Earnings management practices are found in various of companies, both manufacturing, trade and services. Rob (1998) in Zahara and Siregar (2009:88) can prove an indication of earnings management in the banking sector. Some studies in Indonesia also found indications of earnings management practices in the banking sector. For example are the study conducted by Zahara and Siregar (2009), Adyawardana (2010), Padmantyo (2010), Setiawati (2010), Utami (2010) and Syahfandi (2012).

To minimize the earnings management practices, it is necessary to implement good corporate governance mechanism. This mechanism is discussing how to adjust the relationship between the various parties both inside and outside the company as the board of commissioners and directors, shareholders and stakeholders, employees and authorities. This relationship is very essential because to keep the checks and balances that enable an oversight between each party to the other party (http://www.bi.go.id, 2013).

Good corporate governance has done to ensure that the owners or shareholders are abtained the returns from the activities undertaken by the agent or manager (Schleifer and Visny, 1997 in Siswantaya, 2007:5). The attention to good corporate governance has improved, especially since the collapse of the large U.S. companies such as Enron Corporation and Worldcom. Several studies on good corporate governance indicated that the implementation of good corporate governance may not be well implemented in Indonesia as it is still relatively new concept. As study conducted by Siswantaya (2007), Wisnumurti (2010), and Subhan (2012).

Good Corporate Governance (GCG) needs to be done in a variety of companies, including banks. The bank is a business of trust and disappear from the national banking universe. Therefore, GCG is required to ensure that the bank is well managed by professionals with a clean track record, and follow the rules in order to assure the interests of stakeholders (http://www.bi.go.id, 2013).

Islamic Bank is a bank that operates on the principles of Islam or sharia, in contrast to the principle of the conventional banks. Islamic bank is not only demanded to generate commercial profit, but also demanded to be fully operational the values of Islam or sharia. Although the principle of the two types of banks are different, they are both bound by the rules set by the government and Central Bank. The performance assessment in Islamic bank is not different with conventional banks (Zahara and Siregar, 2009:88).

Islamic Bank as a financial institution which is active on the basis of principles of Islam, it is not ought to do manipulation activities in any form, including in financial reporting, as the media of information for its users and assessment tools conducted by the government and Central Bank. The engineering activities such earnings management is frequently done by conventional banking sector in Indonesia and it is not expected to influence the Islamic banking practices which still relatively new in Indonesia (Syahfandi, 2012:1).

Several researchers conducted a study to test the earnings management practices in Islamic banks, for example Zahara and Siregar (2009) and Setiawati (2010) concluded that the ratio of camel influence has no significant influence on earnings management in Islamic banks while Syahfandi (2012) find evidence that Islamic banks do earnings management with the income smoothing practice. The results of previous studies show Islamic banks can not be separated from the practice of earnings management.

Islamic banks ought to do good corporate governance in order minimize earnings management. Islamic bank in Indonesia should comply the Central Bank Regulation No. 11/13/PBI/2009 related to the implementation of good corporate governance for Islamic General Banks and Islamic Business Unit.

Results of prior research prove the influence of corporate governance on earnings management for example the study of Siswantaya (2007) about good corporate governance and earnings management on companies listed on Jakarta Stock Exchange. It shows corporate governance mechanism failed to border of earnings management behavior. Kartikasari (2011) prove good corporate governance have significant effect towards earnings management in banks and similar with Subhan (2012) prove good corporate governance have significant effect towards earnings management in banks because the relatively low awareness of GCG implementation in Indonesia.

Therefore, based on various prior research, this study reexamine about connection between good corporate governance and earnings management practices. This study expand the study of Suhardjanto and Dewi (2011), it is examine the influence of good corporate governance which proxied by the board of commissioner size, the number of the board of commissioners meeting, the independent commissioner composition, the independent audit committee composition, the number of the audit committee meeting. This study also expand the study of Siswantaya (2007), it is examine the influence of good corporate governance which proxied by institutional ownership and managerial ownership. Besides that, many previous studies use banking companies listed on Indonesia Stock Exchange for the study object, for example Wisnumurti (2010), Kartikasari (2011), Suhardjanto dan Dewi (2011) dan Subhan (2012).

Since several prior research showed the inconsistency of research results and have not found studies about good corporate governance with earnings management in Islamic banks, this study aims to reconfirm the influence of corporate governance on earnings management with the study object in Islamic banks. Therefore, the researchers compiled a study entitled: **"The Influence of Good Corporate Governance to Earnings Management Practices on Islamic Banks in Indonesia"**

## 1.2 Problem of the Study

Based on the background of the study which the formulated problem is: Does good corporate governance which proxied by the board of commissioner size, the number of the board of commissioners meeting, the independent commissioner composition, the independent audit committee composition, the number of the audit committee meeting, institutional ownership and managerial ownership have an influence to earnings management practices?

## 1.3 Objective of the Study

The objective of this study is to examine the influence of good corporate governance in the form of the board of commissioner size, the number of the board of commissioners meeting, the independent commissioner composition, the independent audit committee composition, the number of the audit committee meeting, institutional ownership and managerial ownership to earnings management practices in Islamic Banks in Indonesia.

## 1.4 Significance of the Study

This study contributes to:

a. Academics.

This study is expected to add to the literature in financial accounting.

b. Science development.

This study is expected to contribute to the development of theoretical studies, especially those related to financial accounting about good corporate governance and earnings management practices.

c. This study is expected to be a reference for future researc and be an input to the shareholders of the company particularly Islamic banking to realize good corporate governance.

## 1.5 Limitation of the Study

The analysis in this study is limited General Banks and Islamic Business Units are which published the annual report and partial report (financial condition) during 2010-2011.