CHAPTER I

INTRODUCTION

1.1 Research Background

Global Financial Crisis (GFC) that occurred in the years before and after 2008 caused many companies to experience bankruptcy. China is one of the countries experiencing Global financial crisis. In the years before and after 2008 many companies experienced a decline in earnings of the company, this causing the company to manipulate earnings to maintain the earnings quality in the company, thus the investors still trust the company and company will be saved.

Earnings management continues to be an important issue in the field of financial accounting, but the literature to date has only provided limited evidence on firm's earnings behaviors in response to GFC, particularly with regards to developing countries such as China. The comparisons of the mean absolute values of earnings management indicators in periods before and after 2008 performed in this study showed that the top Chinese listed firms analyzed did engage in earnings management during the GFC period.

In response to the GFC, firms from the construction material industry manipulated earnings upwards through discretionary accruals, whereas firms from the construction and engineering industries engaged in accrual-based income-increasing earnings management. The manufacturers of household durables, such as domestic appliances, electronics and TVs managed earnings downwards via discretionary accruals. The findings reflect the effects of the stimulus package launched by the Chinese Government to combat the GFC. This made the earnings quality of the company become less. This current study also generated empirical evidence that firms' earnings behaviors are affected by their characteristics. The characteristics are from the financial statements, some of them are profitability, liquidity, company size, earnings growth, and others.

The 2008 GFC, which is also known as the subprime mortgage crisis as a result of the bursting of housing bubbles in the USA around 2005 and 2006 (Lahart, 2007), has had a substantial impact on the world economy. This is illustrated by significant reductions in the annualized gross domestic products (GDPs) of some of the world's major economies. At the beginning of 2009, the annualized rates of decline in GDP were 6.8 per cent in the USA, 14.4 per cent in Germany, 15.2 per cent in Japan, 7.4 per cent in the UK and 9.8 percent in the Eurozone (Baily and Elliott, 2009). In addition, some emerging economies with strong economic growth have experienced dramatic slowdowns. Of these, during the period from 2007 to 2009, Cambodia experienced the largest reduction in GDP growth rate, from above 10 per cent to approximately 0 per cent. India's GDP growth rate dropped from 9.2 to 7.4 per cent, Mexico's from 4.8 to 1.3 per cent, Malaysia's from 5.9 to 4.6 per cent and, in Kenya, it dropped from approximately 7.0 to 3.0 per cent. As the largest developing economy, China was also affected by the GFC. From the second half of 2007, China's economy exhibited a downtrend, which was reflected by declines in several major aspects of the country's economy. The economic growth rate in China had averaged 9.8 per cent annually before the 2008 GFC. However, it dropped to 9.0 per cent in the second half of 2008 and then to 6.1 per cent in early 2009. In 2009, the export growth rate became negative for the first time at 16 per cent, and the total value of exports declined by US$229.08bn. In the stock market, the composite indices of the Shanghai and Shenzhen stock exchanges decreased significantly by 65 and 62 per cent, respectively, after peaking in 2007.

It has been argued that the adverse effects of the GFC on emerging economies, including China, were mainly caused by a significant drop in their exports to major developed countries (Liu, 2009; te Velde et al., 2009). The major developed countries are the main markets for the emerging economies' exports, and dramatic declines in consumption in those developed countries resulted in reduced demand for the products exported from developing countries. Liu (2009) presented empirical evidence indicating that the impact of the crisis on China was significant. A 1 per cent decline in economic growth in the USA, the EU and Japan is likely to result in a 0.73 per cent decline in the growth rate of China. A report by te Velde et al. (2009) from the Overseas Development Institute suggests that growth rate reductions in developed countries are likely to result from decreases in trade, commodity prices and investment. A report in the China Digital Times in 2010 also blamed the crisis in the USA and Europe for the downturn in China's growth. "When the USA and Europe fell into the credit crisis earlier this year, they were forced to cut back on consumption, which fuelled a massive decrease in demand for Chinese imports". Economic data collected by the National Bureau of Statistics of China are concordant with this assertion. Besides the influence of external factors, some scholars have argued that the deterioration in China's economy since the second half of 2008 also resulted from internal aspects of China's economy. Zhang (2009) suggested that China is bound to pass through another trough in its economic cycle; its national economy would be heated or overheated and cooled or overcooled from time to time every several years, and other internal economic factors contributed to the economic slowdown in China in 2008. Overall, the economic slowdown in China in 2008 and 2009 mainly resulted from the GFC that commenced in 2007, and the situation was exacerbated by internal aspects of China's economy.

Beside the economic factors, there is another factor that makes company doing the earnings management. Some research supports that manipulation of earnings is also often done by management. The preparation of earnings is done by the management who knows more about the conditions within the company. The condition can cause problems because management as the party giving information about the performance of the company is evaluated and rewarded based on the report made by it.

Management is not the owner of the company but management is the person who runs the company, therefore the profit generated company can become less qualified. This separation of ownership can lead to conflicts in the control and execution of corporate governance that cause managers to act in the best interests of the owner. Conflicts resulting from this separation of ownership are called agency conflicts. Agency conflict is the conflict between management as executor and shareholders as owner.

The agency conflict that result in the opportunistic nature of management will result less earnings quality. The low of earnings quality will make mistakes of decision makers to the users like investors and creditors, resulting in reduced corporate value. Profit as part of the financial statements does not present the actual facts about the economic condition of the company can be doubted its quality. Profits that did not show actual information about performance management may mislead the users of the report. If such profits are used by investors to form the market value of the firm, then profit cannot account for the actual firm market value (Boediono, 2005). One measure of earnings quality is accruals. Accrual is the difference between the accounting earnings of the firm and the underlying cash flow. High positive accrue indicates higher earnings than the resulting cash flow.

The tendency of management shows a large profit makes investors and creditors often make a mistake by just looking at net income at face value and ignoring the quality of earnings over the financial statements presented. Lack of quality information on profits can occur because of lies deliberately done by the presenter to mislead the users of these financial statements. Profit that is less qualified can happen because in running a company business, management is not the owner of the company. This separation of ownership can lead to conflicts in the management and management of the company that cause managers to act inappropriately with the wishes of the owners. This conflict cannot be separated from the tendency of managers to gain personal benefits at the expense of the interests of the owners.

Continuing the discussion on the GFC, Chinese Government launched a series of measures to mitigate the impact of the GFC on China's economy and maintain the country's economic growth. The most significant of these was a stimulus package provided by the central government, amounting to US$580bn (or 4 trillion RMB), which accounted for approximately 14 percent of 2008's GDP. This stimulus package involved thousands of projects, and more than 60 per cent of it was invested in the construction of infrastructure, including railways, highways and airports. The rest was invested in social and people's-livelihood programmers, such as the "household appliances to the countryside" initiative included in the "San Nong policy". These governmental interventions were swift and decisive, and, thus, they successfully salvaged China's economy in 2009. Yu (2009) concluded that these governmental responses were admirable because the slowdown in China's growth did not last more than a quarter, and the Chinese economy rebounded strongly with annual GDP growth of 7.9 per cent in 2008 and more than 8.0 per cent in 2009.

Besides that, China has mad the huge for economic strides, it faces a number of enormous economic challenges to rebalance its economy for sustainable economic growth and playing an increased role in promoting international and regional economic and financial cooperation. Despite its heavy export dependence, China was able to take forceful policy actions to reduce the negative effects of the global recession. This made China become strong and increasing their economics.

China is having an increasingly large impact on the global economy, but economic interdependence runs strongly in both directions. China's growing economic strength has led to a decoupling from developments in the advanced economies is greatly overstated. The analysis also revealed that the magnitudes of accrual-based and cash flow-based earnings management are influenced by firm characteristics such as firm size, leverage, and profitability. These all characteristics include in the financial statements of the company.

The financial statements are the important things to know the company's financial condition. The financial statements are basically the result of the accounting process used as a communication tool for the user of the financial data of a company's activity with the parties concerned with the data of the company's activities. The financial statements for a company become a basis to be able to determine or assess the company's financial position, the results of the analysis of financial statements made the parties concerned to take a decision. Therefore, the financial statements should be able to describe the financial position and business results of the company at a certain time reasonably. In the Statement of Financial Accounting Concepts (SFAC) no.2 Qualitative Characteristics of Accounting Information explains that one of the qualitative characteristics must have accounting information for the purpose of financial reporting achieved is prediction.

The Statement of Financial Accounting Concept (SFAC) No.1 (1992) issued by the Financial Accounting Standard Board (FASB) gives an indication in the accounting profession that financial reporting should have benefits in order to help users to evaluate the performance of the company, where profit is one information from financial statements that can explain the company's performance over a period in the past. Earnings information in the financial statements is very important for the purpose of making various decisions. Earnings information is important for investors to know the quality of corporate profits, therefore the earnings quality is important concern for investors and accounting policy makers.

Imad Zeyad Ramadan (2015) examines the factors that affect the earnings quality. The results showed that financial leverage, firm's performance, investment decisions and accounting conservation statistically significant direct impact on earnings quality. These results are consistent with the view that the greater the company's earnings are, it becomes the less likely to practice creative accounting or earnings management, what led to increased earnings quality. Also, these results are consistent with the point of view that external creditors are considered as external control tool over management's performance, what in turns, reduces the agency cost and reduces the likelihood of practicing creative accounting or earnings management, which will reflect positively on the quality of earnings. This research shows that accounting conservation plays a role in the reduction of the practice of creative accounting or earnings management.

Shehu Usman Hassan PhD, and Musa Adeiza Farouk (2014) examines the firm attributes have impact on earnings quality in oil gas companies in Nigeria. This study findings that leverage, liquidity and firm growth has a significant positive impact on earnings quality, while the firm size, institutional ownership and profitability have a significant but negative influence on earnings quality.

Based on Guanglu Xu and Xudong Ji (2015) researches, China's top listed firm (based on total assets) did engage in earnings management in the periods before and after 2008 when the GFC started. Investigation on earnings management directions revealed that in response to the GFC, the firms from construction-related industries and the airlines industry manipulated earnings upwards through either accrual-based and/or cash flow-based earnings management activities. The GFC as factors that affected earnings management in the period 2008 make earnings quality of company become less. These findings reflect the effect of the stimulus package launched by the characteristics such as size, leverage, profitability and growth affected the earnings management behaviors of the firms analyzed in this study.

Based on the explanation research background above, the writer would like to study about the quality of profit in Chinese manufacturing companies as measured by earnings management with discretionary accrual models. This will be showed that China as a country that already have a title as good economic growth, have less earnings management, also the earnings quality is good. Thus, the writer took the title of research is "The Influence of Company Size, Profitability, and Leverage on Earnings Quality at manufacturing company listed in Hong Kong Stock Exchange (HKEX) 2014-2015 Period".

1.2 Identification and Limitation of Problem

1.2.1 Identification Problem

Based on the research background above, the identification problem of this research are follow:

a. Global Financial Crisis become one of the factors that cause the company to do earnings management, thus that earnings quality becomes low, especially in Chinese company.
b. Low of firm size, profitability and leverage affect the company to do earnings management, whether the quality of profit in the company become less.

1.2.2 Problem Limitation

The problem limitation, it's necessary to make a clear the hedging of problem analyzing. The aim is to prevent the deviation problem. The problem scopes of this research are:

1. In this research dependent variable used is Earnings Quality that can be measure with Discretionary accruals in model modified Jones, and then used leverage, size, and profitability as a component to measure the independent variable.
2. This research is only for manufacturing company that has positive profit which is listed on Hong Kong Stock Exchange.
3. This research used secondary data which is company's annual report that listed in Hong Kong Stock Exchange on period 2014-2015.

1.3 Problem Questions

The problem questions which will be discussed in this research are:

a. What is the effect of Size on Earnings Quality in manufacturing companies listed on HKEX?

b. What is the effect of Leverage on Earnings Quality in manufacturing companies listed on HKEX?

c. What is the effect of Profitability on Earnings Quality in manufacturing companies listed on HKEX?

1.4 Purpose of Research

The aims of this study are as follow:

a. To analyze the effect of size on earnings quality in the company

b. To analyze the effect of leverage on earnings quality in the company

c. To analyze the effect of profitability on earnings quality in the company

1.5 Research Aiming

The research aiming is to obtain information and then the information expected can be applying properly by the user. Different users have different benefits, the specification of users and its benefits are as follow:

1. For writer

   The writer can get much information and knowledge to understand about the manufacturing company in Mainland China, also the writer known that earnings quality is influenced by many factors, some of them are the four factors that have been studied in this research.

2. For manager or company

   This study will give the manager or company information about their earnings quality and could help them to keep increase their profit and make company better.

3. For investor

   Investors always need a lot of information before they decide to do the investment. The information is not only from the annual report but also from another resource. This study may be able to help the investor do the decision.

4. For the next researcher

   This study can be used as references for the next researchers who need similar information in the future.