

## CHAPTER I

### INTRODUCTION

#### 1.1 Background of The Study

A company needs funds to finance its operations. One of them is by the debt. Debt can come from bank loans or corporate bonds. Cost of debt is the rate of return that must be repaid to the company's debts. The return rate is the expected yield for the willingness of investors and creditors bear the risk. This is what makes company urgently needs to consider the cost of corporate debt. If the company's cost of debt is high, then the selling costs of company's products will also increase due to increased production costs. This condition will be hard to compete with other companies. Company will also be difficult to accept projects due to high cost of debt. The company will be difficult to accept the project if the estimated cash flows of the company is not as profitable (counting based on the present value of future cash flows).

World Bank site reveals a comparison between inflation and interest rates to borrow. In ASEAN comparison between inflation and borrowing interest rates have varied differences. World Bank data shows that interest rate to borrow as one proxy for measuring cost of debt, in Indonesia, in 2012 at a rate ranging from 12.4% to 5.4% of inflation which is higher than some other ASEAN countries such as Malaysia from 4.9% to 3.2% of inflation, Singapore from 5.4% to 5.3% of inflation, and Thailand from 6.9% to 3.8% of inflation. Cost of debt in Indonesia is quite high. The interest rate is also higher than China which is in the range from 6.6% to 5.45% of inflation. It shows that interest rate to borrow in Indonesia

by taking into account the inflation rate is still quite high which indicates a high cost of corporate debt in Indonesia.

An interest rate is the rate at which interest is paid by a borrower for the use of money that they borrow from a lender (creditor). Interest rate set by the central bank of country as a reference to relative interest rate to each country. In Indonesia, the interest rate set by Bank Indonesia become the basis for calculating interest rates. When the interest rate set by Bank Indonesia increased, then at the same time interest rate set by the company when issuing bonds will also increase, so the interest rate that can be borrowed or proxied by cost of debt will increase as well.

High cost of debt is also due on each business risks. When the government raises the interest rate, the increase is also borne by the investor. Business risk is the potential change in the level of return on an investment. Business risk is the uncertainty in projections of the company for return or profit in the future. Keown et al. (2010) suggested that cost of debt is the rate of return expected by investors over the debt, which is the return that is required when giving a loan to the company. In order to understand the business risks of a company, stakeholders (internal or external parties) need sufficient information about a company. The required information was obtained from financial statements of company. In terms of financial reporting, managers can perform earnings management to mislead stakeholders of the company's economic performance. Earnings management is accounting policy choice by manager in order to achieve his own goals. Meanwhile, according to (Copeland in Utami, 2005), earnings management is

management efforts to maximize or minimize income, including income smoothing in accordance with the desire of management.

Manager knows more about the company's internal information and prospects in the future than the owner. This privilege is used by managers as an opportunistic behavior in disclosing information about the company. Supposedly the manager shall provide a signal about the state of the company to the owner through disclosure of accounting information in the financial statements. However, most of the times the information submitted is not acceptable according to the actual condition of the company. This condition is known as asymmetric information that received by investors as a bad signal. Bad signal derived from earnings management practices in company. When the information is not real at the same time the quality of financial reporting is in doubt. The doubtful of financial reporting leads to lower earnings quality. It means investors are aware that they have to bear high risk over uncertainty. This uncertainty will lead to high cost of debt.

Companies with good conditions indicated by the effectiveness of the company to utilize its resources. The utilization of resources is characterized by the ability of the company to be able to generate profits from its activities. In this study, researcher prefer to use account receivable turnover and inventory turnover to analyze how company's activities in making profit. Measurements with that ratios were chosen to do in the consumer goods company. The consumer goods company must have a high activity of the company. This company has the characteristics of trading and manufacturing companies simultaneously. The

identity indicates a good signal to be able to assess the activity of the company, especially in generating profits. Moreover, if company really has good activity, surely, the tendency to perform earnings management is not required. Similarly with debt. If both corporate activity and profit target is achieved, then the company does not have to pay the high cost of debt, as funding from the company's borrowing will also be smaller.

In line with this, Rao and Rao Madhusudhana Prahlada (2009) stated that the activity of the company is important to establish a chain of company performance. Effectiveness of the company indicating the best time to utilize the company's activities in generating profits. The company must be able to adapt to the appropriate time in order to move well so that continuity of the company is also guaranteed. As a form of improvising its business, as well as the company should maintain its effectiveness.

Empirical research that support high cost of debt due to earnings management practices supported by research Valipour and Moradbeygi (2011). They observed that the low quality of earnings, will result in a higher cost of debt. The low earnings quality due to earnings manipulation detected by investors as a form of earnings management. It can be concluded that firms aggressively use accruals to manage earnings to avoid covenant violations and reduce the cost of financing, including cost of debt.

This result is in contrast to Gray, Koh and Tong (2009) which states that there is no relationship between earnings management in the accrual process with high cost of debt of the company. Their research in Australia concluded that the

quality of accruals that are not associated with the cost of debt. The quality of accruals considered only affects cost of equity in the equity market, but had no effect on cost of debt in debt market.

Previous studies have shown inconsistent results. Therefore, researcher will examine the effect of earnings management on the cost of debt. In this research effectiveness of the company is used to examine whether effectiveness of the company will strengthen or weaken the relation between earnings management and the cost of debt. In accordance with this background, the researcher is interested to research **“The Influence of Earnings Management on The Cost of Debt (An Empirical Study on Listed Consumer Goods Companies in Indonesia Stock Exchange).”**

## **1.2 Identification of The Problem**

As related to the background, the identification problem are as follows:

1. What is the reason of company in considering its cost of debt?
2. Do company’s effectiveness describe earnings management practice?
3. Do earnings management influence on the cost of debt?
4. Does company’s effectiveness moderate on the relation of earnings management and cost of debt?

## **1.3 Limitation of Problem**

The problem of this research is limited to the influence of earnings management on the cost of debt that moderates by company’s effectiveness which are accounts receivable turnover and inventory turnover on listed consumer goods companies in Indonesia Stock Exchange (IDX) during in 2012.



#### **1.4 Research Question**

From the background of the problem, the research questions are formulated as follows :

1. Do earnings management influence on the cost of debt?
2. Does company's accounts receivable turnover moderate the relation of earnings management and cost of debt?
3. Does company's inventory turnover moderate the relation of earnings management and cost of debt?

#### **1.5 Research Objective**

According to the problem, research objectives are as follows:

1. To analyze the influence of earnings management on the cost of debt
2. To analyze the influence of accounts receivable turnover to the relation of earnings management and cost of debt
3. To analyze the influence of inventory turnover to the relation of earnings management and cost of debt

#### **1.6 Research Contributions**

The contributions of the study are as follows:

1. For researcher, to prove empirically the influence of earnings management on the cost of debt
2. For academics, the results of this research are expected to contribute additional information that available for students in studying similar material
3. For next researchers, as reference material and resources to conduct further research