CHAPTER 1
INTRODUCTION

1.1. Background

Financial statements are the financial analysis information base of an entity that can be used to manage financial and economic activities of the entity, to assess the effectiveness of its management, and to choose the directions for investing capital (Osadchy, Akhmetshin, Amirova, and Bochkareva, 2018). Financial statements help the related entities to create informed decisions on the basis of making good decisions based on accurate data. The purpose of making financial statements is as information to identify the financial condition of the entity that will be used as a means of making economic decisions for management. Financial statements are issued generally at the date which the financial statements are authorized and issued by managements. The financial statements that have been published by the company can be used in making investment decisions based on the assessment of each user of the financial statements. In preparing the financial statements, the importance of using the information contained in it to function for many things related to the company cannot be missed. Therefore, the preparation of financial statements must be adjusted to the applicable financial accounting regulations and standards. Accuracy of information in financial statements is an important factor that can influence decision making by users, both of which can be applied in terms of transparency and completeness of information presented by companies to users of financial statements (Abdulshakour, 2020)

Investors utilize financial statements to make decisions regarding the valuation and financial condition of an entity to get a better picture of whether investing in the related entity is a wise decision. Before investing in an entity, investors try to extract and understand information by processing several financial statements to predict the financial quality of a company. The goals of high-quality financial statements are to force management of an entity to improve earnings quality to indicate high performance which will contribute to a stable market price movement that involves estimating accurate future returns (Darjezi, 2016 as cited in Siladjaja and Anwar, 2021). Earnings quality is a measurement of how earnings are reliable for assessing the current and future performance for an entity. Earnings quality manages the expectations of future earnings which in case of low earnings quality will generally result in lower expectations of future earnings. The adjustment of market valuation indicates low earnings quality by increasing the cost of capital in response to the adjustment which would mean that earnings quality is a priced risk factor. Therefore, high-quality financial performance positively contributes to the market reaction which leads investors to estimate the cost of future capital accurately. Earnings quality has a positive effect in Egyptian (Eldeeb, 2018) and Jordanian (Saleh, Abu Afifa, and Alsufy, 2020) stock performance in the stock exchange market. This research has shown that earnings quality influences the performance of an entity and suggested that high relevance of accounting information will improve earnings quality.

Earnings quality is an important part of financial statements as contained in the earnings of an entity. This happens because investors are going to buy the future earnings coming from entities current year earnings as reported. Several studies with mixed results have shown that earnings quality is determined by several factors such as firm performance, accounting conservatism, firm size, performance, leverage, and liquidity. One of the factors that can affect earnings quality is intellectual capital. Intellectual capital is the intellectual material such as knowledge, information, intellectual property, experience of an entity that can be utilized for wealth creation. Such examples of intellectual capital are: talents and abilities of groups or individuals; social and technological networks; and intellectual property (Stewart, 1997, as cited in Ahlgren, 2011). Intellectual capital can be considered as an asset that contains all informational resources an entity can utilize for wealth creation. Intellectual capital is considered as a strategic resource of an organization that allows an entity to obtain competitive advantage in the fierce market competition (Xu and Wang, 2018). Relevance and reliability of financial information determines the quality of financial reporting that needs qualified financial accounting standards (IFRS, 2018). Relevancies of financial information has the meaning that the accounting information can explains the relation of price and stock return which also determine the usage of financial statement users to take decisions. Any information within the financial statements can be defined as relevant if the information can affect investors economic decisions. Relevancies of accounting information must be able to confirms entity's historical economic performance which can corrects past mistakes and be able to predict future stock price variation (Lestari, Kamaludin, dan Midiastuty, 2016). Financial information reliability in the other hand has the criteria and qualified to be free from modification, illegal transactions, intentional misstatements, fraud, or irregularities. Manipulation of financial data shows the lack of reliability value in the entity's financial report which resulting in doubts by the investors.

Earnings management is an action that manipulates financial records to improve the appearance of financial position using accounting practices that produce desired financial statements that reflect the financial performance of a healthy entity (Agustia et al., 2020). The purpose of earnings management is to demonstrate reasonable earnings quality that meets the investors expectation and the requirement of obtaining relevant authorization from regulators (Cug and Cugova, 2021). An entity quality of earnings is disclosed through removing any irregularities existing in the financial statements. High Quality earnings could improve the stock market efficiency; therefore, investors must be interested in information quality of high financial performance (Mojtahedi, 2013). The interest of investors with high quality financial information could cause the management of an entity to manipulate financial statements to draw the attention of investors. Positive earnings that show financial condition improvement could be used to improve the existence of an entity.

One of the earnings management cases that occurred in Indonesia some time ago was the scandal in the financial statements of PT. Garuda Indonesia (GIA), which is alleged to have inflated its financial statements. In the Financial Accounting

Standards, there are guidelines for how to recognize revenue for the management of a company. Company management can choose the structure of business transactions to be carried out with other parties to meet certain Financial Accounting Standards (SAK) requirements. In this case, PT. Garuda Indonesia runs a cooperation transaction with PT. Mahata Aero Technology for the provision of in-flight connectivity services between PT. Mahata Aero Technology and PT Citilink Indonesia as a subsidiary of PT. Garuda Indonesia received as much as 239.94 million US dollars and recognized revenue from the parent company (Bhakti Utami and Ary Kartikasari, 2021). The recognition of this transaction caused GIA expense became fluctuated. Payment of value added tax and income tax also affected by the recognition. Supposedly, these tax expenses are yet to be paid by GIA because their transaction are not yet stated in the financial statement. The case with GIA became a polemic to the public. One day after a report of financial statement signature refusal became public, GIA stock price decreased to Rp. 478 per share or decreasing by 4.4% from Rp. 500 per share. Until the closure of stock exchange, GIA stock price plummets down to Rp. 466 per share (Utami and Kartikasari, 2020). In the financial statements of GIA, it can be concluded that GIA management has enacted earnings management.

Earnings became a priority for an entity because it is one of the reasons for management to make decisions. An Entity will take an effort to gain high profit and sustaining earnings which could greatly affect earnings quality. Earnings quality is considered high if the earnings in the current year can be utilized to predict future earnings of an entity which shows that the focus of measuring the earnings quality closely related to the characteristics of financial statements (Pagalung and Sudibdyo, 2012). The determination factors of earnings information are the factors that influence the earnings quality itself. The main motivation of management to conduct earnings management is an opportunistic purpose which elevates earnings to increase compensation that will be received (Farichah, 2017). Opportunistic purposes tend to disserve financial statements users because information delivered by management becomes inaccurate and does not describe fundamental value of the company which will be responded negatively by investors. Research by Jaya and Agustia (2021) has found that intellectual capital has a positive impact on earnings management. Intellectual capital is able to determine the operational performance as such an entity management with high intelligence will impact on company performance. Intellectual capital and earnings management has a significant effect on future stock returns (Sugiyanto, 2020). The main goal of a company is to maximize stock return because a high return in a company reflects the ability of profit creation (Beylin, 2016, as cited in Sugiyanto, 2020).

Previous research made by Kalalo and Sofian (2022) has found that intellectual capital has positive effect to earnings quality which meant that if the high intellectual capital is high, then the entity's earnings quality is also high, this research is supported. Kalalo and Sofian (2022) also found out that intellectual capital has negative impact on earning management which can be concluded that high intellectual capital meant the entity's earning management is low this result is supported. Results from Kalalo and Sofian (2022) research are supported by Vernanda (2019) and Darabi, Rad, and Ghadiri (2012). These results are the opposite with research made by Indra and Trisnawati (2019) which found out that intellectual capital did not affect earning quality nor earning management. Conclusion from Indra and Trisnawati (2019) research is that intellectual capital did not guarantee or affecting the quality of earnings and earnings management. However, Indra and Trisnawati (2019) research found out that that earnings management negatively affects earning quality which meant that earnings management will lower the quality of earnings. Although intellectual capital did not affect earning quality, however, with earnings management as the intervening variable, intellectual capital could have significant effects to earnings quality.

The inconsistency of previous research became the motivation for this research to be held regarding the effects of intellectual capital on earnings quality with earnings management as intervening variable. This research populations are manufacturing companies that have been listed in Indonesian Stock Exchange during 2020 and 2021. Although manufacturing companies are known to use technologies rather than human resource, but with advanced development, entities combine both with intellectual capital to achieve competitive advantage. This research period of 2020 and 2021 are taken to ensure latest and in-depth information.

1.2. Problem Formulation

Based on the background that has been written, the formulation of the problem in this study is as follows:

1. Does intellectual capital affect earnings quality?
2. Does intellectual capital affect earnings management?
3. Does earnings management affect earnings quality?
4. Does intellectual capital affect earnings quality using earnings management as intervening variable?

1.3. Research Purpose

Based on the problem formulation that has been formulated, the research objectives are as follows:

1. To provide empirical evidence of the influence of intellectual capital to earnings quality using earnings management as intervening variable
2. To provide empirical evidence of the influence of intellectual capital to earnings quality
3. To provide empirical evidence of the influence of intellectual capital affect earnings management

4. To provide empirical evidence of the influence of earnings quality affect earnings management

1.4. Research Advantage

By carrying out this research, the benefits that can be given to several parties can be described as follows:

a. Academic benefits:

It is hoped that this research can be a reference for further research regarding the effect of intellectual capital to earnings quality using earnings management as moderation.

b. Practical benefits:

It is hoped that this study will benefit companies regarding the insight of intellectual capital and increasing the quality of earnings.

1.5. Thesis Writing Systematics

In order to make it easier for readers, this research is divided into 5 chapters, namely:

CHAPTER 1: INTRODUCTION

This section describes the background of the research, problem formulation, research objectives, research benefits which are divided into academic benefits and practical benefits, as well as the systematics of writing proposals.

CHAPTER 2: LITERATURE REVIEW

This section describes the theoretical basis, previous research, developing hypotheses, and also the conceptual framework of the research.

CHAPTER 3: RESEARCH METHOD

This section describes the research design, identification, operational definition and measurement of variables, types and sources of data, data collection methods, population, sampling, and sampling techniques, as well as research data analysis.

CHAPTER 4: RESEARCH FINDINGS AND DISCUSSIONS

This section describes the general picture of the research object, data description, results of data analysis and discussion.

CHAPTER 5: RESEARCH FINDINGS AND DISCUSSIONS

This section describes the conclusions of the study, limitations during the study, and suggestions for future research.