CHAPTER I
INTRODUCTION

1.1. Background

Financial statements are the result of recording a company's financial transactions, which show the company's financial condition in a specific accounting period. Financial statements are the primary tool for managers to demonstrate the effectiveness of achieving goals and carry out the corporate accountability function. External parties relied on the company's financial report to assess its performance. Essentially, this report communicates the financial health of the company to investors. It can be used to attract the interest of investors and can help boost the company’s growth.

According to Financial Accounting Standards (SAK), a financial report is part of a complete reporting process that includes a balance sheet, an income statement, and the presence of a statement of changes in financial position (cash flow, or flow of funds, notes, and other statements). Statement of Financial Accounting Concepts (SFAC) number 2 in FASB (1989) stated that income information is the main element in financial reports and is very important for parties who use it because it has predictive value. Financial reports reflect the company's condition because they contain information about the financial position, management performance reports, cash flow statements, and company financial position changes (Ferdiansyah, 2014).

The presentation of the financial statement is strongly recommended to be fully disclosed and transparent thus as not to mislead readers of the financial statement (Antonia, 2008; Kalbuana *et al*., 2020). Financial reports' quality, application, and actuality require a qualified auditor. In auditing financial reports and when errors or fraud occur, integral auditors are always on guard (Wiryadi & Sebrina, 2013; Arnas *et al*., 2021).

Accounting profit is one of the most valuable pieces of information for shareholders (Saihi, 2015; Peni & Vahamaa, 2010; Elsye Hatane *et al*., 2019).

Accounting rules and standards affect this income, which may depend on management judgment, as in the case of accruals (Weil, 2009; Elsye Hatane *et al*., 2019). Ferdiansyah (2014) stated that in financial statements, the size of the company's profit usually acts as the main parameter. This management performance appraisal can encourage deviant behavior on the part of company management, one of which is earnings management. Roychowdhury (2006) in Istanti *et al*. (2021) states that Real Earnings Management (REM) is management's motivation to provide wrong understanding to stakeholders by distorting the company's normal operating activities. Managers manipulate financial reports by using their judgments in financial statements and preparing transactions to change financial reports to provide misleading information to some stakeholders about company performance (Healy & Wahlen, 1999; Rachmawati, 2020). Factors that motivate managers to take REM actions include management's opportunistic behavior to maximize their utility related to the compensation and intensity received. According to Gunny (2010), earnings management practices, both accruals and real, are thought to affect the quality, reliability, and value relevance of financial statements (Istanti *et al*., 2021).

In response to this, there are reasons for managers to manipulate the financial statements based on Galdipour *et al*. (2014) in Rachmawati (2020). First, political costs can motivate managers to smooth profits against reported earnings. Second, efficient contracts can be used as an excuse to manipulate reported earnings since shareholders may call for the dismissal of managers due to low-income levels. As a result, managers manipulate earnings by selling depreciated assets, reducing the allowance for bad debts, changing accounting estimates, etc. All that can be done to protect the positions they hold.

One of the cases that occurred in Indonesia related to earnings management was a case carried out by a well-known air transportation company in Indonesia (PT Garuda Indonesia Tbk). This case involved the refusal to sign the company's financial statements by Dony O. and Chairul T. as commissioners of Garuda. They objected to the recognition of revenue of USD 239.94 million originating from a cooperation agreement between PT Citilink Indonesia as a subsidiary of Garuda

Indonesia and PT Mahata Aero Technology (Mahata) regarding debt for connectivity services. This rejection was made because Garuda had recognized the cooperation transaction that allegedly did not receive the incoming payment as an item of income.

The company management's decision to carry out earnings management will undoubtedly reduce the quality of earnings from a company's financial statements. Quality earnings are real profits without earnings management in earnings information submitted by companies which can lead to low-quality financial reporting. (Siallagan & Machfoedz, 2006: Utami, 2020). Unfortunately, earnings management seems to have become a corporate culture practiced by all companies in the world (Aulia, 2013). The consequences of this managerial engineering activity damage not only the economic order but also the ethical and moral order (Ferdiansyah, 2014). In addition to reducing the possibility of earnings management, it is essential to pay attention to the need for good corporate governance. A good company must have corporate governance that can practice minimizing earnings management by differentiating the types of management and managerial shareholding structures (Alfarano, 2005; Lambert, 2012; Arnas *et al*., 2021).

The Indonesian Financial Services Authority (OJK) and the International Finance Corporation Advisory service created corporate governance guidelines to provide a robust framework for good corporate governance (CG) practices for corporations (International Finance Corporation, 2014; Elsye Hatane *et al*., 2019). Companies can use Institutional ownership to monitor managers' earnings management behavior to reduce it. Institutional ownership can monitor managers' performance in managing the company so that ownership by other institutions is expected to reduce earnings management behavior by managers (Ningrum, 2021). Managerial ownership is considered one of the components that influence earnings control through managers. If managers have ownership in the organization, supervisors will act in the interests of shareholders because managers also have an interest in it. The scale of managerial shares in a business entity can show the alignment of interests between management and shareholders. However, if the interests of managers and owners can be aligned. Then managers will no longer be motivated to manipulate information or perform earnings management to improve the quality of accounting information and earnings information. Increased managerial ownership is expected to reduce earnings management practices which are intended to reduce the value of discretionary accruals.

The corporate governance structure includes institutional ownership, managerial ownership, audit committee, and independent commissioners. Putri and Ulupui (2017: 4) in Sari & Astika (2021) explain that good corporate governance is a mechanism for good company management based on regulations, laws, and ethics to increase accountability to stakeholders and provide added value to the company in the long term. The goal of good corporate governance is to protect the rights of stakeholders from the expropriation of their managers and the rights of insiders and controlling shareholders. Corporate governance is used to describe all influences that affect the process of appointing those who decide how operational control is carried out to produce goods and services and all external influences that affect operations or controllers (Turnbull, 2000; Surifah, 2017).

It is generally agreed that audit committees play an important role in corporate governance, particularly in enhancing the effectiveness of the board of directors in monitoring management (Klein, 2002; Smith Report, 2003; Spira, 2003; Li *et al*., 2012). Based on the regulations of the Capital Market Supervisory Agency (BAPEPAM), companies that are members of the Indonesia Stock Exchange (IDX) are required to have an audit committee. The audit committee is tasked and responsible for (1) encouraging the creation of an adequate internal control structure, (2) improving the quality of financial disclosure and reporting, (3) reviewing the scope and accuracy of external audits, the fairness of external audit fees and the independence and objectivity of external auditors, and (4) prepare a letter outlining the duties and responsibilities of the audit committee during the financial year examined by the external auditor (Tjager *et al*., 2003; Sirait *et al*., 2014). The audit committee plays a very important role in assisting the board of commissioners in carrying out their duties related to accounting policies, internal controls, and company financial reporting practices (Sawyer, 2005; Sirait *et al*., 2014). The level of understanding and level of good accounting education reflects a good measure of audit committee expertise so that they can prepare quality financial statements (Istanti *et al*., 2021).

There are three categories of intellectual capital, namely customers, structural capital, and human capital (Yudhanti & Shanti, 2011; Arnas *et al*., 2021). Boekenstein (2006) in Arnas *et al*. (2021) explain human capital as employee knowledge, while structural capital is the knowledge of the client's entities and customer capital (Ulum, 2009; Arnas *et al*., 2021). Intellectual capital is considered the foundation of company growth, and the strategic role of intellectual capital grows and even becomes a major part of increasing company value (Chen, 2004; Arnas *et al*., 2021). Audit quality is influenced by human capital. Auditors with good human capital will be able to find errors in the financial statements so that the financial statements avoid material misstatements and provide high-quality audit results (Dali *et al*., 2019). In addition, human capital plays an important role in increasing audit quality and also mediates the relationship between audit committee quality on earnings management.

The concept of intellectual capital has begun to receive great attention among academics and practitioners. Some believe that intellectual capital is the main factor that can affect the success or failure of a company to achieve its goals, especially when intense economic competition and the continuous search for improvement and development are observed (Mouritsen, 2001; Abdelrahman *et al*., 2014). As supported by Fatima (2012) in Kalbuana *et al*. (2020) explained that the role of intellectual capital is increasingly strategic and has even become a major/important role in efforts to increase company value. This is due to considering intellectual capital as the basis for company growth.

Numerous researchers have tried to examine and analyze the relationships between ownership structure and earnings management conducted by Ferdiansyah (2014), Surifah (2017), Hatane *et al*. (2019), Arnas *et al*. (2021), dan Susanto *et al*. (2021). Susanto *et al*. (2021) show that institutional ownership of earnings management is significant and negative. They argue that the number of shares owned by institutional investors can monitor management and tend not to do earnings management. In addition, these researchers found that managers have performed opportunistic earnings management. Therefore, it is important for companies to implement a corporate governance system to direct earnings management from the opportunistic spectrum towards efficiency. Earnings management is an accounting policy or action chosen by a manager to influence profits to achieve certain goals (Scott, 2012; Surifah, 2017). Research by Wulanda & Aziza (2019) and Sutarmin (2017) shows that managerial ownership has a significant negative direction towards earnings management. This study proves that managerial ownership can reduce earnings management actions because when managers are also owners of the company, the interests of management and shareholders are aligned, and managers will improve their performance.

Research that examines the relationship between audit quality on real earnings management conducted by Li *et al*. (2012) proves that audit committee expertise and the number of audit committee meetings associated with intellectual capital affecting in fewer earnings management. Other researchers, such as Sirait *et al*. (2014), Li *et al*. (2012), Astuti *et al*. (2020), and Buallay (2018), examined the relationship between audit quality and intellectual capital but provided no relation with earnings management. Therefore, studies that show the relationship between institutional ownership, managerial ownership, audit committee quality with earnings management, and intellectual capital as a mediating variable need to be conducted more.

Hence, based on the previous research mentioned above, this research continues the work of previous scholars, with the following differences. First, this study is conducted to investigate the influence corporate structure of the company on its earning management. Second, this study investigates the effect of audit committee quality on the arising of earnings management. Lastly, this study presents human capital as part of the intellectual capital variable as a mediating variable between the relationship of corporate governance, audit committee quality, and earnings management because it was rarely investigated in previous studies as research conducted by Astuti *et al*. (2020) stated that the better the audit committee quality of a company, the more information and quality will be provided to give a good signal to the stakeholders.

The existence of IC as a mediating variable is expected to bridge the differences in previous research results. This study was conducted to explore the role of intellectual capital in mediating determinants of earnings management as part of the implementation of Good Corporate Governance. Based on the background and the phenomenon explained above. Therefore, this research has the purpose of examining and is conducted with the title of **"The Role of Intellectual Capital as A Mediation of Relationship Between Corporate Governance and Audit Committee Quality Towards Earnings Management (Case Study on Consumer Goods Sector Listed on The Indonesia Stock Exchange)."**

1.2. Research Problem Formulation

1.2.1. Problem Statement

The cases regarding the practice of earnings management aren't such a novelty happened in Indonesia. Therefore, to find out the cause of the problem and the solution to the problem, this research was conducted to improve previous research. In consequence, a question arises regarding does institutional ownership (IO), managerial ownership (MO), and audit committee (AC) quality has a significant influence on earnings management (EM), with human capital (HC) as a mediating variable on consumer goods sector listed in IDX?

1.2.2. Research Question

Based on the background of this research, therefore the problems formulated by the author aim to answer these questions:

1. Does institutional ownership have a negative effect on earnings management?
2. Does managerial ownership have a negative effect on earnings management?
3. Does audit committee expertise have a negative effect on earnings management?

4. Does the number of audit committee meetings have a negative effect on earnings management?
5. Does institutional ownership have a positive effect on human capital?
6. Does managerial ownership have a positive effect on human capital?
7. Does audit committee expertise have a positive effect on human capital performance?
8. Does the number of audit committee meetings have a positive effect on human capital performance?
9. Does human capital performance have a negative effect on earnings management?
10. Does human capital mediate the managerial ownership on earnings management?
11. Does human capital mediate the expertise of the audit committee on earnings management?
12. Does human capital mediate the number of audit committee meetings on earnings management?

1.3. Research Objectives

The objectives of this research are to provide empirical evidence of the role of intellectual capital as a mediation of the relationship between corporate governance and audit committee quality towards earnings management in the consumer goods sector listed on the Indonesia Stock Exchange.

The objectives of this research are as follows:

1. To know and analyze the influence of institutional ownership on earnings management.
2. To know and analyze the influence of managerial ownership on earnings management.
3. To know and analyze the influence of audit committee expertise on earnings management
4. To know and analyze the influence of the number of audit committee meetings on earnings management.

5. To know and analyze the influence of institutional ownership on human capital.
6. To know and analyze the influence of managerial ownership on human capital.
7. To know and analyze the influence of audit committee expertise on human capital performance.
8. To know and analyze the influence of the number of audit committee meetings on human capital performance.
9. To know and analyze the influence of human capital performance on earnings management.
10. To know and analyze whether human capital mediates managerial ownership on earnings management.
11. To know and analyze whether human capital mediates the audit committee expertise on earnings management.
12. To know and analyze whether human capital mediates the number of audit committee meetings on earnings management.

1.4. Research Contribution

Based on the explanation of the objectives of this study above, the following are the expected contributions of this study in the future, either directly or indirectly:

1.4.1. Theoretical Contribution

Theoretical contributions expected from this research are:

1. The findings will be able to provide knowledge about the role of intellectual capital as a mediation of the relationship between corporate governance and audit committee quality towards earnings management.
2. The findings will generate the extent of literature in terms of the role of intellectual capital in mediating the factors affecting earnings management.
3. Able to make intellectual capital an indicator in measuring the occurrence of earnings management in future research.

1.4.2. Practical Contribution

The practical contributions are explained as follows:

1. For Company

Earnings management is often used as a tool to conceal the private benefits received by managers, insiders, and the controlling shareholder (Cornett *et al*., 2009; Crocker and Slemrod, 2007; Sweeney, 1994; Defond and Jiambalvo, 1991; Abdolmohammadi *et al*., 2010; Jaggi *et al*., 2009; Prencipe *et al*., 2008; Wright *et al*., 2006; Surifah, 2017). Thus, the results of this research are expected to provide useful insights for the consumer goods sector to improve their intellectual capital as an indicator in measuring the occurrence of earnings management in order to enhance better earnings quality in the future.

2. For Auditors

The results of this research are expected to be a motivation and an understanding for auditors to enhance better audit quality. So, they can find a more effective way to detect material misstatements and maintain and improve their independence to report any material misstatements to the public.

3. For External Parties

The results of this research are expected to explain the role of intellectual capital in strengthening/weakening the influence of earnings management (specifically, in this case, include good corporate governance and audit committee quality) and the value of the company that will help business practitioners, investors, financial analysts, and the Government of Indonesia to evaluate the effectiveness of intellectual capital, to encourage the implementation of corporate governance and the quality of audit committee in Indonesia which can lead to abuse of earnings management, in order to enhance the value of the companies.