# Chapter I

# Introduction

## 1.1. Background of the Study

The financial function is one of the important functions in a company's activities. In managing the financial function, one of the aspects that need to be considered is the extent to which the company is able to meet the funding needs used for operations and business developments (Anggie Nur Safitri S & Sholichah, 2021). To meet these funding needs, the company can obtain funds either from within the outside of the company (debt) or from the company (equity).

The financial report serves as the company's communication tool, allowing interested parties to connect. Earnings management is closely related to the significance of financial statements that show profits adjusted to the wishes of the company's management. This principle is linked to conservative accounting practices and is not distinct from management's desire to maximize their interests at the expense of shareholder welfare (Krisnanda, 2024).

According to (Pinem et al., 2024), the current accounting framework, profit is defined as the difference between the accrual method of measuring income and costs.  In the context of accounting, earnings quality encompasses the accuracy of all profits that the business reports.  When a business presents earnings data that is not consistent with the real situation, it is deemed to have low quality earnings. This biases the data and may cause creditors and investors to make poor decisions. Accounting profits are considered to be of high quality when they accurately represent a company's true operational performance. However, the use of the accrual basis in accounting introduces concerns regarding earnings quality, as it may provide opportunities for management to engage in earnings manipulation.

Accounting standards that permit earnings management can substantially influence both capital markets and the broader economy, which underlies the importance of "The Influence of Profitability towards Earning Quality".

The research by (Salma & Riska, 2019) indicates that partial tests reveal profitability and leverage affect earnings quality; however, the liquidity ratio does not impact the earnings quality of the company. In contrast, (Putri, 2020) assert that liquidity significantly positively affects earnings quality.

Furthermore, the research that implemented by (Wulan Astriah et al., 2021), which analyzed manufacturing firms listed on the Indonesia Stock Exchange (IDX) between 2017 and 2019, found that leverage did not significantly influence earnings management within these companies. In contrast, profitability was shown to have a positive impact on earnings management during the observed period.

Prior studies on earnings quality have produced inconclusive and inconsistent results, underscoring the need for further empirical investigation into its determinants. This study contributes to the literature by examining a distinct dataset comprising manufacturing firms listed on the Indonesia Stock Exchange (IDX) between 2021 and 2023. The analysis focuses on key firm-specific variables—profitability, leverage, liquidity, firm size, and sales growth—which represent diverse subsectors with varying characteristics and operational dynamics. This approach allows for a more comprehensive evaluation of the factors influencing earnings quality in the manufacturing sector.

Manipulated financial reporting has become a growing problem in Indonesia, endangering the reliability of financial statements and eroding stakeholder trust.  This phenomenon occurs when management intentionally presents financial information that does not accurately reflect the company's current situation, often in order to meet earnings targets, attract investors, maintain stock prices, or secure performance-based incentives.

This phenomenon can be explained using agency theory, which emphasizes the conflict of interest between managers and shareholders. Managers, acting as agents, may seek personal gain, especially if their compensation is based on short-term profitability. Signaling theory is also relevant, as companies frequently use profitability as a signal of strong financial performance, even if reported profits do not accurately reflect actual earnings quality.

One well-known example is PT Indofarma Tbk., where the Audit Board of Indonesia (BPK) revealed in May 2024 that the state lost roughly Rp 371.8 billion as a result of financial misstatements from 2020 to 2023. These misstatements were not isolated errors but the company included fraudulent transactions, overstated revenues, and poor financial management. According to media reports, despite showing profitable performance in its financial statements, the company engaged in a variety of manipulative practices to distort its financial condition.

The increasing amount of evidence indicates that high profitability does not always translate into high earnings quality. Companies can report impressive profits while concealing underlying weaknesses, raising concerns about whether profitability is a reliable indicator of financial performance. Understanding the relationship between profitability and earnings quality is critical, especially when it comes to ensuring transparent and trustworthy financial reporting. This study aims to investigate that relationship, particularly in the Indonesian manufacturing sector, where financial fraudulent reporting remains a potential risk.

Based on the above description, the researcher is motivated to conduct this study due to the inconsistency of previous research findings. In addition, it is also due to the numerous cases of financial statement manipulation of large Indonesian companies found by the *Badan Pemeriksa Keuangan (BPK)*, indicating deviations in financial management (Yuniar & Andayani, 2024). Thus, the author is interested in conducting a study titled "The Influence of Profitability on Earning Quality".

### 1.2. Problem Formulation

The problem formulation in this research, based on the issues described in the study's background, is: Does Profitability have a significant influence towards Earning Quality?

### 1.3. Objective of the Research

This study evaluates the influence of Profitability on Earning Quality according to the problem formulation.

### 1.4. Benefit of the Research

This research is expected to bring in both theoretical and practical advantages, detailed as follows:

1. Theoretical Benefits

This study aims to enhance the current understanding in accounting, particularly concerning the factors that influence of earnings quality, including profitability. Additionally, it might be used as a guide for upcoming research projects that concentrate on reporting quality and financial performance.

2. Practical Benefits

Practically, the findings of this study are anticipated to be advantageous for multiple stakeholders. The research offers investors and stakeholders insights into the financial stability and earnings quality of manufacturing companies, thereby facilitating more precise and strategic investment decisions. This study underscores the financial determinants that significantly impact earnings quality, providing a foundation for enhancing the reliability and transparency of financial reporting within the manufacturing sector. It can serve as a valuable resource for academics and future researchers focusing on financial statement analysis and corporate performance assessment across the manufacturing industry.

### 1.5. Problem Limitation

The outline of the research problem refers to the following components such as:

- The concentration of the research is manufacturing companies that listed on the Indonesia Stock Exchange (IDX), excluding companies from other sectors.
- The period of the research is limited to the years 2021-2023, which may not reflect the long-term trends.

- The variables implemented consist of Profitability as the independent variable, Earning Quality as the dependent variable, and Leverage, Liquidity, Company Size, and Sales Growth as the control variables.