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A Conceptual Model of Intellectual Capital and Earnings Quality: The Moderating Effect of Political Connection

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ABSTRACT--*Earnings quality reflects the integrity and quality of financial reporting which minimizes the information asymmetry and agency conflicts among management, owners, majority and minority shareholders. The issue of earnings quality has become a concern, especially in respect of intellectual capital as an intangible asset where it's the most controversial accounting subjects in the modern era.As such, the present model sheds some light on the salience of significant role of intellectual capitals ingredients (human capital, structural capital, relational capital) in improving the level of earnings quality. The study also proposes that political connections as a moderating variable, which affect the relationship between intellectual capital and earnings quality. Political connections have often been considered as an independent variable that affects the level of earning quality in prior research. In this study, the role of political connections as a moderator variable is to extend its role from an independent variable in prior research.Finally, this study is expected to serve as a guide for the regulatory bodies such as global stock exchanges, financial institutions management as well as academic researchers.*

Keywords--*Earnings Quality, Intellectual Capitals, Political Connection.*

I. INTRODUCTION TO EARNINGS QUALITY

Since the early 2000s.the literature has highlighted the earnings quality as one of the most important accounting issues, where the significance of earnings quality subject is precipitate by its high relationship with the importance of financial information provided to financial statement users(Gaio & Raposo, 2014). Earnings quality is defined as the grade of pertinent information that a firm can give financial statement users in their decision-taking (Dechow, Ge, & Schrand, 2010). It is the quality of accounting information that a corporate provides to financial statement users,the downturn in equity markets in the generality of the states around the world has been related to the shortage of financial accounting information transparency and quality. Financial scandals in the United States and European country have raised worry about the quality of financial accounting information, a situation that has given rise to concern for investors, specifically with relevance to earnings reported(Gaio & Raposo, 2014; Himmah, 2018).The company's scandals including big corporates cross country, like Enron, WorldCom, Parmalat, Satyam in India, Tesco Plc's in the United Kingdome, Toshiba in Japan, through others, and the breakdown of the financial foundations, such as Lehman Brothers, Fortis, and AIG, with the economic stagnation, have led to a large loss in investors trust in corporate disclosure validity, which lead to doubt regarding companies reporting(Bhasin, 2016; Huynh, 2018; Marzuki, Wahab, & Aswadi, 2016; Melé, Rosanas, & Fontrodona, 2017; Tasios & Bekiaris, 2012;

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Wan Mohammad, Wasiuzzaman, Morsali, & Zaini, 2018).The world financial crisis as well assured and drew awareness to the significance of transparency for supporting fair competition, investment, and improving trust on the public and company sectors accountability(Persakis, 2018).

In addition, the case implicit the financial reporting quality is not only the major worry to the financial users but also to the community, as it influences economical decisions(Tasios & Bekiaris, 2012). The quality of financial reporting in the corporates annual report stock helpful information to assist users in making the right decisions about the corporate based on the information in the annual report, which have to reflect the true financial and merchant position of the corporate(Alzoubi, 2019).

Elevated earnings quality, financial reporting translucence and audit are significant to the investors and all stakeholders. the worry about the earnings management connection with the last high-profile scandals in accounting have risen amongmost of the investor's community to demand earnings quality, which is so efficient for the aim of improving the financial statements quality (Bedard & Johnstone, 2004; Latif, Bhatti, & Raheman, 2017).In the accounting literature, earnings quality deemed as one of the major features of accounting quality. whilst, earnings management deemed as one of the major attributes of earnings quality. Earnings management and earnings quality are like of the duo side of the same coin, where Earnings quality is the reverse of earnings management, that is, increased earning management lead to decreased earning quality (Azzoz, Abdel, & Khamees, 2016; Ewert & Wagenhofer, 2013).

The present study focuson investigate the relationship between intellectual capital and earning quality, where the study ofSarea and Shaima (2016)indicated that the evolving literature surrounding the explanation of the connection between the intellectual capital ofcorporates and earning quality had led to a heated discussion among the researchers around the world. Furthermore, the study aims to contributes to a growing literature by examining the moderating role of political connection among the variables that mentioned above.

II. THEORETICAL BACKGROUND

Prior research provides a rich basis of theory that explains in earnings quality. This section will define and discuss the theoretical framework of the research model

1.1 Intellectual Capital

Intellectual capital comes with a high importance for business success, growth and long-term sustainability(Squicciarini & Voigtländer, 2015). In addition, it gives the firms the momentum and energy to compete in the market(Bratianu & Orzea, 2013).It is also considered a key value driver and strategic element to enhancing the competitiveness of the companies(Lerro & Schiuma, 2013). Mouritsen and Roslender (2009)indicated that intellectual capital leads to the development of new positive relationships between staff, customers, technologies and the organization itself. Likewise, Murthy and Mouritsen (2011)in their case study of an Australian Bank (Bank of New South Wales) studied the relationship between the intellectual capital and financial capital. They find that intellectual capital has a positive impact on financial capital and on the bank's value.In addition, they find that the investment in human capital results in the development of organizational and relational capital and the other components of intellectual capital.

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Intellectual capital is increasingly attractive field for academic and professional studies from different angles, it was definedas the intellectual material that has been formalized, captured and leveraged to create wealth(Stewart & Capital, 1997). Moreover, intellectual material is the combination of an organization's patents, processes, employees' skills, and technologies, and information about customers and suppliers, and old-fashioned experience(Lerro, Linzalone, & Schiuma, 2014; Stewart & Capital, 1997). Along the same lines, Sveiby (1997)(P. 9-11) defines intellectual capitalas all intangible assets that enable the firm to achieve its goals, he also and among other pioneers in the field of intellectual capital Stewart and Capital (1997),Bontis (1998), Saint-Onge (1996),Malone (1997) have divided intellectual capital into three sub-categories: employees' competencies (Human Capital), internal structure (Structural Capital) which includes policies, concepts, patents, administrative and technological infrastructures. Finally, the external structure (Relationship Capital)which is identified as the relationships with customers, suppliers, and providers that affect the firm's image and reputation in the market. In addition, some professional and standards setting bodies introduced definitions for intellectual capital and its categories or components, for instanceCIMA (2003)offered a comprehensive definition for the intellectual capital: as the proprietorship of knowledge, practical experience, technologies, customer's relations and specialized skills that provide the firm with a competitive advantage in the market. This broad concept of intellectual capital is further classified into three sub-categories of capitals:

a. Human Capital: this is presented by CIMA as all intellectualities implied by the staff of the firm that leaves it at the end of the working day. This includes all skills, experiences, tacit knowledge, professional training, creativity, innovation, staff loyalty, management competences and all attributes relating to good quality employees.

b. Relational Capital: all useful resources that connected to external parties with whom firms have a relationship. This includes customers, suppliers, research and development partners, and indirectly all relations that exist by dealing with these parties e.g. reputation, a firm's mental image and the loyalty of customers.

c. Organizational Capital: this is introduced as the tacit knowledge, which stays at the firm at the end of the working day, and includes systems, plans, IT infrastructures, copyrights, intellectual properties e.g. patents, franchises, and trademarks.

Over years, many methods were developed for measuring intellectual capital including; Balanced Scorecard (BSC), Skandia Navigator, Intellectual Capital Index, Direct Intellectual Capital Method, Human Resource Accounting, Book-to-Market Ratio, Tobin's Q, Value Added Intellectual Coefficient and Economic Value Added (Salehi, Enayati, & Javadi, 2014). However, it's important to differentiate between two close terms; the value of intellectual capital and efficiency of intellectual capital. According to NKujansivu and Lönnqvist (2007)the value of intellectual capital refers to the amount of intellectual capital; how much intellectual capital a firm has in term of monetary units, while the efficiency of intellectual capitalis a concept that describes how efficiently a firm's intellectual capital creates value for it. This study will focus on the efficiency of intellectual capital to find its relationship with the firm's earnings quality.

However, in the literature there are various studies, which have been conducted in diverse country (US, Malaysia, Taiwan, Australia, Canada, Egypt,Japan, Greece, France, etc.)investigating the relationship between intellectual capitaland firmperformance(Bayraktaroglu, Calisir, & Baskak, 2019; Dženopoljac, Janoševic, & Bontis, 2016; Ferreira & Martinez, 2011; Ho Kim & Taylor, 2014; Khajavi, Ghadirian-Arani, & Fattahi-Nafchi, 2016; Kianto, Andreeva, & Pavlov, 2013; Sardo & Serrasqueiro, 2017) most of these studies showed an association

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between intellectual capital and firms performance and have documented a significant positive relationship among intellectual capital and its components and firms financial performance.Moreover, low firms' performance is one reason for earnings management (Watts & Zimmerman, 1990; Weisbach, 1988). When managers do not manipulate accounting transactions and financial figures, earnings reported by the firms would reflect the true performance of them because the earnings are the products of genuine business transactions and calculations(Saleh, Jaffar, & Yatim, 2013).Theoretically firms that exhibit poor performance are expected to engage in accounting tactics such as window dressing to present a better picture of their earnings that show poor earnings quality (Madhumathi & Ranganatham, 2011). In sum, a high level of intellectual capital and its components improves firm's financial performance and reduces earnings management where consequently leads to higher earnings quality(Khajavi et al., 2016).

1.1.1 Human Capital

Human capital is rooted in a certain way in thetalent of employees. Human capital consists of components such as knowledge, expertise, skills, experience, and competence (Sydler, Haefliger, & Pruksa, 2014). According to Snell and Dean Jr (1992),Lee, Swink, and Pandejpong (2011) human capital will be greater if there are highly skilled employees, employees have great knowledge and are considered as best people in the organization, employees are experts in their particular jobs and functions, employees have useful experience.

A few studiesinvestigated the association between intellectual capital also its components and earnings quality(Darabi, Rad, & Ghadiri, 2012; Darabi, Rad, & Heidaribali, 2012; Khajavi et al., 2016; Sarea & Shaima, 2016; Zanjirdar & Chogha, 2012). These studies have showed that there is a significant positive relationship betweenthe intellectual capital and earnings quality. One the same vein, the results of statistical test for the study of Darabi, Rad, and Ghadiri (2012) among 948 firm-year observations from Iran stock market, showed that intellectual capital and its human capital component have a significant positive impact on earnings quality. Moreover, the findings of the studies of Khajavi et al. (2016) and Sarea and Shaima (2016)show that human capital have significant impact on earnings quality.Theseresults complies with the resource dependency theory is used as the theoretical underpinning for the relationship between the intellectual capital as a firms significant resources and the transparency and the quality of financial reporting(Hillman & Dalziel, 2003).Thus, theseventh hypothesis is developed:

H1: Human capitalis positively associated withand earnings quality among corporates.

1.1.2 Structure Capital

Roos, Edvinsson, and Dragonetti (1997) described that the structural capital refers to what remains in the company when employees go home for the night, such as brands, patents, processes, organizational structure and concepts. According to Bontis (1998), if an organization has poor systems and procedures to monitor its action, then the overall intellectual capital will not reach its fullest potential. Chen, Zhu, and Yuan Xie (2004) argued that structural capital deals with the mechanism and structure of an enterprise that are helpful in supporting employees' endeavor to have highest intellectual and overall business performance.

Several prior studies have focused on the association between structure capital and earnings quality. (Darabi, Rad, & Ghadiri, 2012; Khajavi et al., 2016; Mojtahedi, 2013; Sarea & Shaima, 2016; Zanjirdar & Chogha, 2012).

Moreover, the studies of Khajavi et al. (2016)and Darabi, Rad, and Ghadiri (2012) have investigated the impact of structure capital on the earnings quality, they findings indicated that structure capital have insignificant effect on earnings quality. On other hand, the study of Sarea and Shaima (2016)in the Bahrain context, found a significant relationship between structure capital and earnings quality.In contrast, Mojtahedi (2013) in a sample of 100 Malaysian firms during the years 2000 and 2011, found a positive association between structure capital and earnings quality. Thus, theeighth hypothesis is developed:

H2: There is a positive relationship between the structure capitaland earnings quality.

1.1.3 Relational Capital

Relational capital represents the potential an organization must deal with and benefit from its relationships with external stakeholders. This intangible relationship includes the knowledge embedded in customer relations, interactions with suppliers and government or related industry associations(Bontis, 1998). Bontis (2001) broadened this definitionby arguing that the relational capital captures any positive relationships with third parties such as customers and suppliers.

Numerous theoretical and empirical studies in the literature have indicated that low firms performance is one reason for earnings management(Watts & Zimmerman, 1990; Weisbach, 1988). Where Madhumathi and Ranganatham (2011) indicated that firms that exhibit poor performance are expected to engage in accounting tactics such as window dressing to present a better picture of their earnings that show poor earnings quality. In other words, there is a positive relationship between firms' performance and earnings quality.As such, many studies found a positive relationship between intellectual capital and its components (relational capital) on firmsperformance(Baum & Silverman, 2004; Bontis, 1998; Chang, 2004; Prester, 2016). Moreover, the study of Darabi, Rad, and Heidaribali (2012)found a positive relationship between relational capitaland financial reporting quality. Also, the study of Mojtahedi (2013) investigated the impact of relational capital on earnings quality, his results showed a positiverelationship. Thus, theninth hypothesis is developed:

H3: Relational capital among corporates is positively associated withearnings quality.

1.2 Political Connections

The involvement of politicians in commercial business enterprises has received widespread criticism from academic researchers (Chaney, Faccio, & Parsley, 2011; Faccio, 2010). Firms have political connections if their controlling shareholders or top managers are members of parliaments or council of ministers or have close connections with a top politician or party (Faccio, Masulis, & McConnell, 2006) . Extant research mention that politically connected firms suffer from a number of problems including poor financial performance, low financial reporting quality, corruption, operational inefficiencies and lack of investor protection (Chaney et al., 2011; Faccio, 2006, 2010; Hashmi, Brahmana, & Lau, 2018). Businesses tend to develop political connections either explicitly or implicitly. Explicit connections develop through personal ties between politicians and businesses. For example, a firm develops a political connection when a politician officially joins the board of directors or becomes a major shareholder in a firm (Faccio, 2006, 2010; Fisman, 2001). On the other hand, implicit political connections develop through friendships between the senior management personnel of the firm and political figures (Faccio et al., 2006).

Prior studies indicated that the most of politically connected companies have lower financial reporting quality (Chaney et al., 2011; Harymawan & Nowland, 2016; Hashmi et al., 2018; Riahi-Belkaoui, 2004). There are several reasons why the quality of financial reporting of politically connected companies may be lower as compared to non-connected companies. First, connected companies tend to deliberately hide and obscure financial information so as to benefit at the expense of investors (Leuz, Nanda, & Wysocki, 2003). Second, as the study of Chaney et al. (2011) show that political connections have an influence on the financial reporting quality of firms. For example, since firms can secure financing through their political connections, they have less of a need to respond to external market pressures, resulting in the disclosure of lower quality accounting information. Moreover, as connected companies receive benefits from other sources, such as preferential access to finance and lower taxation, they do not focus on reporting high-quality financial information (Chaney et al., 2011; Faccio, 2010).

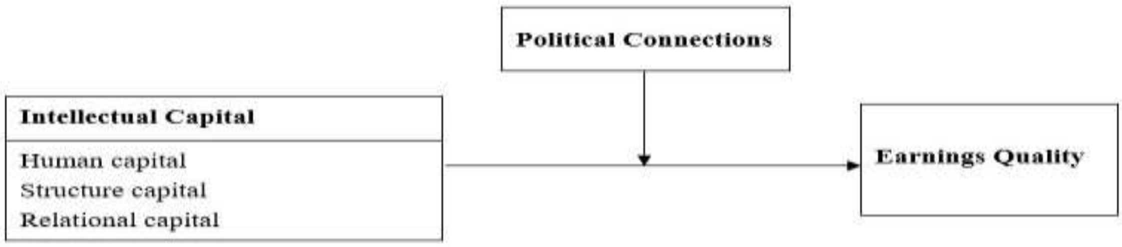
One other hand, the study of Al-dhamari and Ku Ismail (2015) indicated that firms usually have tendencies to closely link themselves to the government or politicians as such linkage provides benefits such as government subsidies, tax discounts, market power, and so on. These benefits ultimately may increase the firms' performance (Boubakri, Cosset, & Saffar, 2012; Faccio, 2006). However, having close ties with the governments may not always benefit the firms because governments seek different objectives that may go against value maximizing objectives and shareholders' wealth maximization.

Moreover, academic researchers argue that governments use firms' resources to benefit their cronies and supporters, who in return provide votes, political contributions, and bribes (Bushman, Piotroski, & Smith, 2004; Gul, 2006; La Porta, Lopez-de-Silanes, & Shleifer, 2002). A review of the literature points to two important ways political involvement can affect earnings quality of politically connected firms. First, since politically connected firms gain from their connections, managers of these firms may have incentives to obscure information in relation to benefits received with the purpose of increasing their wealth at the expense of outside investors (Chaney et al., 2011). Second, governments may pressure politically connected firms to hide information regarding expropriation activities exercised by the governments or their cronies (Bushman et al., 2004). It is suggested that the incentives of controlling managers to report account information with high quality is influenced by political factors (Al-dhamari & Ku Ismail, 2015; Bushman & Piotroski, 2006; Bushman et al., 2004). In this regard, ample evidence from extant research concludes that political influence deteriorates the earnings quality (Al-dhamari & Ku Ismail, 2015; Bushman & Piotroski, 2006; Chaney et al., 2011).

On other hand, a few studies investigated the relationship between political connections and intellectual capital. the study of Hou, Hu, and Yuan (2017)had investigated the non-stateowned companies and founds that political connections impede intellectual capital.Otherwise, the results of statistical test for the study of Tsai, Zhang, and Zhao (2019) among all Chinese listed firms showed that political connections have a positive influence on the intellectual capital.Theseresults are consistent with the resource dependency theory where the level of political connections in the board of directors as an essential resource in the organization will influence on firms' decision making including the outcomes in financial reporting and earnings quality(Mohammed, Ahmed, & Ji, 2017). Thus, the tenth hypothesis is developed:

H4: The political connections moderates the relationship between intellectual capital and earnings quality.

III. RESEARCH FRAMEWORK



IV. CONCLUSION

The literature has highlighted the earnings quality as one of the most important accounting issues, where the significance of earnings quality subject is precipitated by its high relationship with the importance of financial information provided to financial statement users, especially that many stakeholders' use it to make their decisions and predicting future firm performance. wherefore, the study seeks to enrich the previous literature on the context of earnings quality by investigating the impact of intellectual capitals ingredients (human capital, structural capital, relational capital) on the earnings quality. Furthermore, the study also aims to evaluate the influence of political connection as a moderating variable on these relationships.likewise, this study could be useful to regulators in authorities in giving more attention to the significant of earnings quality, overall intellectual capital and political connection.

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