

## FACTORS AFFECTING EARNINGS QUALITY

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Received: June 21,2022 ; Revised: June 24, 2022: Accepted: June 24, 2022

**Abstract:** *The research aims to obtain empirical evidence about factors that affect earnings quality, particularly, the influence of auditor size, audit tenure, audit specialization, firm size, audit committee, leverage, investment opportunity set (IOS), growth opportunity, managerial ownership, and institutional ownership on earnings quality. The population used in this research are all manufacturing companies that are listed in Indonesia Stock Exchange from 2014-2020 and use purposive sampling as the sampling method. Through this method, forty-five (45) manufacturing companies fit with the sampling criteria and chosen as the sample with a total of 135 data. This research uses multiple regression method to analyse the data. The results of multiple regressions show that auditor size, audit tenure, audit specialization, firm size, and leverage have an effect on earnings quality, while the other 5 variables, which are investment opportunity set (IOS), growth opportunity, managerial ownership, and institutional ownership has no effect on earnings quality. Audit specialization has positive effect on earnings quality as those auditors will have deeper understanding regarding the industry, enabling them to better ensure earnings is of high quality.*

**Keywords:** Earnings quality, auditor size, audit tenure, audit specialization, firm size, audit committee, leverage, investment opportunity set, growth opportunity, managerial ownership, institutional ownership.

### INTRODUCTION

Financial statements contain information which are useful for both internal and external users, one of the reasons it is really important is because this information, which is the profit will affect the user's decision (Listyaningsih 2020). However, when looking through the financial statements, investors tend to be more focus on the net income number as they believe it will help them evaluate whether it will be a good investment for them in that specific

company. The truth is, income numbers can be easily manipulated making it less believable which makes earnings quality is more important as it can provide accurate assessment on companies' actual earnings and firms will be able to survive longer when they have high earnings quality (Sae-lim et al. 2019).

Several companies are not able to maintain good performance which results in poor earnings quality (Surya Abbas et al. 2020). For example, PT Industri Jamu and Pharmacy Sido Muncul Tbk, in 2014, they manage to record net

profit growth but in 2016 until 2017, they suffer a decrease in their net profit causing a decline in earnings quality. Another case is Toshiba where they inflate its earnings to 1.2 billion dollars over a period of 5 years (Zubaidah and Nasrizal 2019). This problem will eventually lead to misleading decision as the financial statements are unable to provide actual companies' performance. For this reason, this research is titled "Factors Affecting Earnings Quality" to provide information on some factors that can influence company's earnings quality. This research is developed from research by Sumiadji, Chandrarin, and Subiyantoro (2019) who study the influence of auditor size, audit tenure, and audit specialization, and adding 7 variables, which are, leverage and firm size Purnamasari and Fachrurrozie (2020), audit committee Hamdan (2020), investment opportunity set Listyaningsih (2020), growth opportunity Kwarbai (2019), managerial ownership Khafid and Arief (2017), and institutional ownership Amos et al. (2016) using manufacturing companies listed on Indonesia Stock Exchange from 2014 until 2020.

Based on the research background, the objective of this research is to get empirical evidence on the effect of auditor size, audit tenure, audit specialization, leverage, firm size, audit committee, investment opportunity set, growth opportunity, managerial ownership, institutional ownership on earnings quality.

### **Agency Theory**

This theory explains a relationship between principals and agent which are shareholders and management in which there is a problem called information asymmetry where agent has more information over the principal which results in conflict (Jensen and Meckling 1976). Conflicts occur as both parties have different goals, where the agent wants reward for their efforts, while the principal wants the most wealth on their investment (Nurbach, Purwohedi, and Handarini 2019).

### **Signalling Theory**

According to Murniati (2019), signalling theory shows that company will signal outside parties regarding the actual conditions to attract investors and also it can be used to see prospect or future of the company. The signal given may have positive or negative meanings and this signals sent to investors is used to minimize information asymmetry (Kustono, Roziq, and Nanggala 2021).

### **Stewardship Theory**

In this theory, company is said to be responsible over the resources given to them by the principal (Amos et al. 2016). To achieve their goal, employees will maximize their efficiency and perform good corporate governance which could discourage them from engaging in practices such as earnings management (Folajimi, Salawu, and Shiyabola 2019).

Earnings quality is defined as the quality of earnings which are available publicly and can influence decision making and is used by investors to assess company's performance. High earnings quality will show the company's financial health and also reflects the company's actual performance to provide accurate assessment (Razani and Xia 2017).

### **Auditor Size and Earnings Quality**

Auditor size is usually seen through large scale income of public accounting firm called Big 4, which consists of PricewaterhouseCoopers (PwC), Deloitte Touche Tohmatsu (Deloitte), Ernst and Young (EY), and lastly Klynveld Peat Marwick Goerdeler (KPMG) (Sumiadji, Chandrarin, and Subiyantoro 2019). It is believed that large audit firms have more experience, technique, ability, capital and other factors which allows them to provide more accurate and credibility over earnings information to external users (Putri and Fitriarsari 2017).

Research conducted by Sumiadji, Chandrarin, and Subiyantoro (2019) and Houqe,

Ahmed, and Zjil (2015) stated that auditor size has a positive effect on earnings quality while Putri and Fitriyani (2017) said that there is no significant effect between auditor size and earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>1</sub>: Auditor size has an effect on earnings quality.

### **Audit Tenure and Earnings Quality**

Audit tenure is seen as the term of public accounting firm in providing audit services. There are two possible relationships between audit tenure and earnings quality. Long tenure will provide better understanding of the client and perform audit which can ensure high quality earnings (Sumiadji, Chandrarin, and Subiyantoro 2019). However longer tenure may result in decreasing auditor's level of independence where auditors may violate code of ethics (Zubaidah and Nasrizal 2019).

Research by Razani and Xia (2017) and Sumiadji, Chandrarin, and Subiyantoro (2019) stated that audit tenure has a positive effect on earnings quality while different research conducted by Zubaidah and Nasrizal (2019) stated that there is a negative effect between audit tenure and earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>2</sub>: Audit tenure has an effect on earnings quality.

### **Audit Specialization and Earnings Quality**

Audit specialization is the term used when auditor have more knowledge on a specific industry and will have deeper understanding on the client's industry (Sari and Novasari 2019). They will also be able to identify earnings management better, eliminate unintentional mistake and make less error (Balsam et al. 2003).

Gul, Yu, and Fung (2007) stated that audit specialization has a positive effect on

earnings quality while research by Andayani and Warsono (2009) stated there is a negative relationship between audit specialization and earnings quality. But Sari and Novasari (2019) and Sumiadji, Chandrarin, and Subiyantoro (2019) stated there no influence between audit specialization and earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>3</sub>: Audit specialization has an effect on earnings quality.

### **Leverage and Earnings Quality**

Leverage is used to describe the relationship between company's debt and its assets or resources and it is believed that good company should have more capital than debt (Wati and Putra 2017). Leverage will increase as the risk of financial pressures or bankruptcy also increases.

Positive effect between leverage and earnings quality resulted from research by Wati and Putra (2017) while Purnamasari and Fachrurrozie (2020) stated that leverage has a negative effect on earnings quality. However, Murniati (2019) stated that there is no effect between leverage and earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>4</sub>: Leverage has an effect on earnings quality.

### **Firm Size and Earnings Quality**

Firm size is defined as the size of assets owned by a company and investors tend to have more confidence on larger businesses as it can reflect the way they perform (Warianto and Rusiti 2016). Large firms tend to report profits as it should be and will have higher business continuity which can improve their financial performance (Fitriana and Islami 2018).

Research conducted by Purnamasari and Fachrurrozie (2020) stated that firm size has a positive effect on earnings quality while Wati

and Putra (2017) stated that there is a negative effect between firm size and earnings quality. However, Hakim and Naelufar (2020) stated that firm size has no effect on earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>5</sub>: Firm size has an effect on earnings quality.

#### **Audit Committee and Earnings Quality**

Audit committee is used to monitor and also minimize the asymmetric information between agent and principal in the agency theory (Khafid and Arief 2017). They also serve as tool of corporate governance by monitoring, reviewing, and acknowledging company's financial activities (Sae-lim et al. 2019).

Hamdan (2020) stated that audit committee has a positive effect on earnings quality while Khafid and Arief (2017) stated that audit committee has no effect on earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>6</sub>: Audit committee has an effect on earnings quality.

#### **Investment Opportunity Set and Earnings Quality**

Investment opportunity set is the combination of value of assets with investment choices in the future (Nariman 2018). It is the future investment option with high enough return to increase company's value. Higher IOS will receive stronger response from the market (Zubaidah and Nasrizal 2019).

IOS according to Listyaningsih (2020) has a positive effect on earnings quality but according to Nurbach, Purwohedi, and Handarini (2019) IOS has a negative effect on earnings quality. However, Surya Abbas et al. (2020) stated that IOS has no effect on earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>7</sub>: Investment opportunity set has an effect on earnings quality.

#### **Growth Opportunity and Earnings Quality**

Growth opportunity will allow business to improve their profits and better chances to make investments (Kusumawati and Wardhani 2016). Firms is categorized as growing business if most of their investment produce a high return and said to be more profitable in the future (Yasa 2020).

Growth opportunity has a positive effect on earnings quality according to Kwarbai (2019) but research by Pitria (2017) stated that growth opportunities has negative effect on earnings quality. Laoli et al. (2019) stated that growth opportunity has no effect on earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>8</sub>: Growth opportunity has an effect on earnings quality.

#### **Managerial Ownership and Earnings Quality**

Managerial ownership is shares owned by company's managers or directors. This ownership is said could reduce agency problems as management now have the same position as the shareholders as company's owners (Hatane, Halim, and Tarigan 2019). So, agents will want information that is not manipulated (Asfufi, Srikustono, and Prasetyo 2018).

Managerial ownership according to Khafid and Arief (2017) has a positive effect on earnings quality while according to Asfufi, Srikustono, and Prasetyo (2018), managerial ownership has negative effect on earnings quality. But, Listyaningsih (2020) stated that managerial ownership has no effect on earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>9</sub>: Managerial ownership has an effect on earnings quality.

#### **Institutional Ownership and Earnings Quality**

Institutional ownership is shares owned by corporate organizations which will guide management to behave professionally in

accordance with transparency, equality, and accountability (Listyaningsih 2020). This ownership can discourage management from engaging in earnings management practices which lead to low earnings quality.

Institutional ownership has a positive effect on earnings quality according to Amos et al. (2016) and Kusumawati and Wardhani (2016) while according to Murniati (2019) institutional ownership has no effect on earnings quality. Based on these descriptions, the hypotheses is developed as follows:

H<sub>10</sub>: Institutional ownership has an effect on earnings quality.

## RESEARCH METHOD

This research will use population of all manufacturing companies listed in Indonesia Stock Exchange from 2014 to 2020 using purposive sampling method with the following criteria:

1. Manufacturing companies that are consistently listed in Indonesia Stock Exchange (IDX) from 2014-2020.
2. Companies that consistently used IDR currency in their financial statements from 2014-2020.
3. Companies that consistently have published financial statement as of 31<sup>st</sup> December from 2014-2020
4. Companies that consistently earned profit from 2014-2020
5. Companies that consistently have institutional ownership in their financial statement from 2014-2020.

Earnings quality is defined as earnings that can provide accurate information on current company's performance and reflect the actual earnings. It will be measured using accrual quality based on research by (Sumiadji, Chandrarin, and Subiyantoro 2019):

$$\frac{TA_{jt}}{\text{Total Asset}_{jt}} = \beta_0 + \beta_1 \frac{CFO_{jt-1}}{\text{Total Asset}_{jt}} + \beta_2 \frac{CFO_{jt}}{\text{Total Asset}_{jt}} + \beta_3 \frac{CFO_{jt+1}}{\text{Total Asset}_{jt}} + \beta_4 \frac{\Delta \text{Sales}_{jt}}{\text{Total Asset}_{jt}} + \beta_5 \frac{\text{Fixed Asset}_{jt+1}}{\text{Total Asset}_{jt}} + \beta_6 \frac{\text{Book Value of Equity}_{jt+1}}{\text{Market Value of Equity}_{jt}} + \varepsilon_{jt}$$

Where:

TA<sub>jt</sub> = Net income of company j in the current year  
(-) cash flow of operating company j in year t.

CFO<sub>jt-1</sub> = The company's operating cash flow last year.

CFO<sub>jt</sub> = The operating cash flow of company j in year t.

CFO<sub>jt+1</sub> = The operating cash flow of company j in year t+1.

Sales = Difference in sales of company j years t  
(-) last year t-1.

Total Asset<sub>jt</sub> = Total asset of company j in year t.

Book Value of Equity = Total equity of company j year t+1

Market Value of Equity = Stock market value (\*)  
number of shares of  
company year t.

Auditor size indicates the large scale income and organizations of public accounting firm, called Big 4. Auditor size is measured using a dummy variable where 1 is for companies audited by Big4 and 0 otherwise (Sumiadji, Chandrarin, and Subiyantoro 2019).

Audit tenure defines the terms of public accounting firm in providing audit services. Audit tenure is measured by calculating the number of years in a row the company is audited by the same audit firm (Sumiadji, Chandrarin, and Subiyantoro 2019).

Auditor is seen to have specialization if they have more knowledge on certain or specific industry. Auditor have specialization if the number of companies audited by an auditing firm is more than 15% of the number of companies audited by all auditing firms in a particular

industry group, measured using a dummy variable where 1 is for auditors who have specialization and 0 otherwise (Sumiadji, Chandrarin, and Subiyantoro 2019).

Leverage is defined as the relationships between company's debt to its assets (Wati and Putra 2017). It is measured according to Purnamasari and Fachrurrozie (2020), as follows:

$$Leverage = \frac{Total\ Debt}{Total\ Asset}$$

Firm Size indicates the size of assets owned by a company where it can indicate a high earnings quality (Anam et al. 2020). According to Purnamasari and Fachrurrozie (2020), it is measured using natural logarithm of total assets.

Audit committee exist with the responsibility of monitoring and minimizing the information asymmetry between agent and principals (Khafid and Arief 2017). It is measured using the number of audit committee members elected by BOD according to Hamdan (2020).

Investment opportunity set is the scope of opportunity available or investments which have high enough return to increase firm's value. According to Listyaningsih (2020), it is measured as follows:

$$IOS = \frac{Number\ of\ shares\ outstanding\ x\ Closing\ price}{Total\ Equity}$$

Growth opportunity enables company to have a higher profitability and better prospects

for the company. According to Kwarbai (2019), it is measured as follows:

$$Growth\ Opportunity = \frac{(Sales_t) - (Sales_{t-1})}{Sales_{t-1}} \times 100\%$$

Managerial ownership refers to shares owned by managers or directors of the company itself and according to Khafid and Arief (2017), it is measured as follows:

$$Managerial\ Ownership = \frac{Shares\ owned\ by\ manager\ and\ directors}{Total\ outstanding\ shares} \times 100\%$$

Refers to ownership by institutional investors or corporate entities who can engage with managers. According to Amos et al. (2016), it is measured as follows:

$$Institutional\ Ownership = \frac{Shares\ owned\ by\ institution}{Total\ outstanding\ shares} \times 100\%$$

This research uses multiple regression analysis to assess the relationship between independent variables and the dependent variable (Sekaran and Bougie 2016, 314). Significant level used is 5% and the model is as follows:

$$EQ = \alpha + \beta_1(AS) + \beta_2(AT) + \beta_3(ASPE) + \beta_4(LEV) + \beta_5(FSIZE) + \beta_6(ACOM) + \beta_7(IOS) + \beta_8(GRO) + \beta_9(MO) + \beta_{10}(IO) + \varepsilon$$

## RESULTS AND DISCUSSION

**Table 1 Descriptive Statistics Result**

Variable	N	Minimum	Maximum	Mean	Std. Deviation
EQ	135	0.002603	0.185646	0.03490767	0.029077343
AS	135	0	1	0.46	0.500
AT	135	1	3	1.90	0.813
ASPE	135	0	1	0.51	0.502
LEV	135	0.092483	0.783046	0.37150196	0.175075463
FSIZE	135	11.202935	14.546491	12.53475680	0.717732379
ACOM	135	3	5	3.08	0.301
IOS	135	0.231138	82.444425	4.10533210	10.192098190
GO	135	-0.470921	0.540114	0.07478979	0.126743758
MO	135	0.000000	0.373968	0.04420062	0.096764560
IO	135	0.139775	0.994297	0.69628787	0.187426401

Source: Data output statistics

Table 1 shows that the total data observed by the researcher is 135. Earnings Quality (EQ) with a minimum value of 0.002603 belongs to Ultrajaya Milk Industry & Trading Company Tbk (ULTJ) in 2018, the maximum value of 0.185646 belongs to Merck Tbk (MERK) in 2019. The number of companies audited by big 4 audit firms are 62 companies, the rest of the 73 companies are audited by non-big 4 audit firms.

Audit tenure (AT) has a minimum value of 1 and maximum value of 3. There are 66 companies that used auditor without industry specialization and the 69 companies use auditor with industry specialization.

Leverage (LEV) with a minimum value of 0.092483 belongs to Indospring Tbk (INDS) in 2019, maximum value of 0.783046 belongs to Indal Aluminium Industry Tbk (INAI) in 2018. Firm size (FSIZE) with a minimum value of 11.202935 belongs to Pyridam Farma Tbk (PYFA) in 2017, maximum value of 14.546491

belongs to Astra International Tbk (ASII) in 2019.

Audit committee (ACOM) has a minimum value of 3 and a maximum value of 5 which belongs to Charoen Pokphand Indonesia Tbk (CPIN) in 2017. Investment opportunity set (IOS) with a minimum value of 0.231138 belongs to Argha Karya Prima Industry Tbk (AKPI) in 2019, maximum value of 82.444425 belongs to Unilever Indonesia Tbk (UNVR) in 2017.

Growth opportunity (GO) with a minimum value of -0.470921 belongs to Merck Tbk (MERK) in 2018, maximum value of 0.540114 belongs to Wijaya Karya Beton Tbk (WTON) in 2017. Managerial ownership (MO) has a minimum value of 0.000000 and maximum value of 0.373968 belongs to Arwana Citramulia Tbk (ARNA) in 2019. Institutional ownership (IO) with a minimum value of 0.139775 belongs to Arwana Citramulia Tbk (ARNA) in 2017, maximum value of 0.994297 belongs to Tunas Alfin Tbk (TALF) in 2017.

**Table 2 t Test Result**

Variable	Coefficients	Significance	VIF
Constant	0.143		
AS	0.018	0.002	1.671
AT	0.011	0.000	1.044
ASPE	-0.10	0.049	1.175
LEV	0.042	0.003	1.183
FSIZE	-0.011	0.007	1.704
ACOM	-0.005	0.511	1.193
IOS	-0.00003664	0.886	1.331
GO	-0.022	0.236	1.090
MO	0.005	0.890	2.083
IO	0.015	0.404	2.153

F 4.320 Sig 0.000, AdjR<sup>2</sup> 0.199

Source: Data output statistics

Auditor size (AS) has significance value of 0.002, lower than alpha 0.05. H<sub>A1</sub> is accepted which means that auditor size has effect on earnings quality. Positive coefficient means positive to standard deviation, but standard deviation to earnings quality has negative effect.

It means auditor size has negative effects on earnings quality. The higher the standard deviation error through Big 4, the lower the earnings quality. This result is not aligned with Sumiadji, Chandrarin, and Subiyantoro (2019).

Audit tenure (AT) has significance value of 0.000, lower than 0.05.  $H_{A2}$  is accepted which means that audit tenure has effect on earnings quality. Positive coefficient means that it is positive to standard deviation, while standard deviation to earnings quality has negative effect. It means audit tenure has negative effects on earnings quality. Longer tenure could reduce auditor's independence and cause familiarity threat, it eventually could lead to lower earnings quality (Sumiadji, Chandrarin, and Subiyantoro 2019).

Audit specialization (ASPE) has a significance value of 0.049, lower than 0.05.  $H_{A3}$  is accepted which means that audit specialization has effect on earnings quality. Negative coefficient means that it is negative to standard deviation, while standard deviation to earnings quality has positive effect. It means audit specialization has positive effects on earnings quality. Specialized auditor have greater understanding of the industry, allowing them to ensure earnings is of high quality and not conducting earnings management (Krishnan 2003).

Leverage (LEV) has a significance value of 0.003, lower than 0.05.  $H_{A4}$  is accepted which means that leverage has effect on earnings quality. Positive coefficient means that it is positive to standard deviation, while standard deviation to earnings quality has negative effect. It means leverage has negative effects on earnings quality. Higher debt will encourage management to manage their financial statement making earnings quality lower (Laoli et al. 2019).

Firm size (FSIZE) has significance value of 0.007, lower than 0.05.  $H_{A5}$  is accepted which means that firm size has an effect on earnings quality. Negative coefficient means that it is negative to standard deviation, while standard deviation to earnings quality has positive effect. It means firm size has positive effects on earnings quality. Larger firms will be able to maintain and even improve company's finances,

avoiding earnings management practices (Purnamasari and Fachrurrozie 2020).

Audit committee (ACOM) has significance value of 0.511, higher than 0.05.  $H_{A6}$  is rejected which means that audit committee has no effect on earnings quality. Audit committee is only to comply with regulator's rules and not guarantee greater oversight (Razani and Xia 2017).

Investment opportunity set (IOS) has significance value of 0.886, higher than 0.05.  $H_{A7}$  is rejected which means that investment opportunity set has no effect on earnings quality. IOS is not the main attention when making investment decision (Surya Abbas et al. 2020).

Growth opportunity (GO) has significance value of 0.236, higher than 0.05.  $H_{A8}$  is rejected which means that growth opportunity has no effect on earnings quality. Information on growth is not too responded by investors (Pitria 2017).

Managerial ownership (MO) has significance value of 0.890, higher than 0.05.  $H_{A9}$  is rejected which means that managerial ownership has no effect on earnings quality. Management's share is so small that they are unable to control decision making in company's operations (Listyaningsih 2020).

Institutional ownership (IO) has significance value of 0.404, higher than 0.05.  $H_{A10}$  is rejected which means that institutional ownership has no effect on earnings quality. Lower quality earnings is due to minimal supervision by the company and not affected by institutional ownership (Murniati 2019).

## CONCLUSIONS

Based on the test done before, auditor size has an effect on earnings quality. This result is in line with the research conducted by Sumiadji, Chandrarin, and Subiyantoro (2019). Audit tenure also has an effect on earnings quality, which is in line with research conducted by Sumiadji, Chandrarin, and Subiyantoro



(2019). Audit specialization has an effect on earnings quality, this result is not in line with the research conducted by Sumiadji, Chandrarin, and Subiyantoro (2019). Leverage has an effect on earnings quality, which is in line with research conducted by Purnamasari and Fachrurrozie (2020). Firm size has an effect on earnings quality. This results is in line with research conducted by Purnamasari and Fachrurrozie (2020).

Audit committee has no effect on earnings quality, which resulted different from research conducted by Hamdan (2020). Investment opportunity set has no effect on earnings quality, this result is different with the research conducted by Listyaningsih (2020). Growth opportunity has no effect on earnings quality, which is different from the research conducted by Kwarbai (2019). Managerial ownership has no effect on earnings quality, this result is not in line with research conducted by

Khafid and Arief (2017). Last, institutional ownership has no effect on earnings quality, which is different from research conducted by Amos et al. (2016).

There are several limitations in this research, such as First, the research period is relatively short, which is only 3 years, from 2017-2019; Second, the research population is small, which is only the manufacturing companies listed in Indonesia Stock Exchange (IDX); Third, the adjusted R-Square of this research is only 19.9% of dependent variables variation which can be explained by independent variables. To resolve the limitations mentioned before, these are the recommendations for further research, first, further research is suggested to lengthen the research period; Second, further research is suggested to use another research population, not only manufacturing companies; Third, further research is suggested to add more independent variables.

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