

Factors Affecting Earnings Quality in Manufacturing Companies

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ABSTRACT

This study investigates how profit growth, profitability, liquidity, leverage, firm size, and ownership relate to earnings quality, building on Alvin & Susanto (2022) by adding three predictors. The population comprises manufacturing firms listed on the Indonesia Stock Exchange between 2021 and 2023. A purposive sampling procedure narrowed this to 91 companies, generating 250 firm-year observations analyzed through multiple regression in SPSS. Results indicate that profitability, leverage, firm size, managerial ownership, and institutional ownership significantly affect earnings quality, while profit growth and liquidity show no significant effect. These findings imply that larger, better-governed, and more concentrated ownership firms tend to report higher-quality earnings, offering insights for investors and regulators.

INTRODUCTION

Financial statements record a company financial position over a specific period is summarized in its financial statements (Suteja, 2018). Earnings represent one of the most important elements of a financial statement, as they reflect operating results and are widely used as a basis for dividend policy, performance prediction, decision-making, income-tax calculation, and investment guidance (Fitriana *et al.*, 2019). Reported earnings therefore need to be of high quality and to reflect the company's true condition. However, companies do not always manage to sustain stable or continuously growing earnings (Pane & Rahmadhani, 2021), when earnings falter, managers are sometimes tempted to intervene in the reporting process, producing figures that no longer tell an accurate story. This is precisely what makes earnings quality an important issue.

In simple terms, earnings quality captures how closely a firm's reported profit tracks its actual economic performance. Warrad (2017) states that earnings quality is an indicator used to disclose earnings and to predict a company's future cash flows. High-quality earnings accurately represent the company's condition, are consistent with prior earnings plans, and are stable, sustainable, and useful for predicting future earnings (Fitriana *et al.*, 2019). In Indonesia, several cases illustrate earnings-quality problems, most notably PT Garuda Indonesia Tbk in 2018, which recognized \$239.94 million in unrealized revenue and reported a net profit of \$809 thousand despite still recording losses through the third quarter; a subsequent investigation by the Financial Services Authority (OJK) revealed an actual loss of Rp2.40 trillion, resulting in regulatory sanctions and diminished market trust (Utami & Kartikasari, 2020). This case illustrates the low quality of earnings among Indonesian companies and underscores the need for further research into the factors that influence earnings quality.

Building on the framework used by Alvin & Susanto (2022) in two respects. First, in addition to leverage, firm size, managerial ownership, and institutional ownership, this study adds profit growth, profitability, and liquidity as independent variables, following Indrawati & Rahmawati (2023). Second, while Alvin & Susanto (2022) examined their sample from manufacturing firms on the Indonesia Stock Exchange (IDX) during 2014-2020, the present study shifts the observation window to examines the 2021-2023 period. Taken together, the purpose of this study to generate empirical evidence on how profit growth, profitability, liquidity, leverage, firm size, managerial ownership, and institutional ownership on earnings quality.

LITERATURE REVIEW

Agency Theory

The framework proposed by Jensen & Meckling (1976), describes the contractual bond that links a principal, the shareholder, to an agent, the management team entrusted with running the firm. Shareholders hand managers the authority to run daily operations on the assumption that this authority will be exercised in the shareholders' favor, yet the two parties do not always want the same thing. Owners are chiefly concerned with the firm's continuity and with securing the greatest possible return from the resources under management's control, while managers are paid according to contracts that reward measured performance. Because these interests diverge, and because the principal cannot observe everything the agent does (Sulistyanto, 2008), allowing managers to apply accounting policies that portray a more favorable financial performance (Helina & Permanasari, 2017). This conflict is closely linked to earnings quality: because agents possess more information than principals (Tambun *et al.*, 2017), one manifestation of agency conflict is earnings management, whereby management manipulates financial statements to increase bonuses, secure their position, or meet market expectations. Whenever this happens, earnings quality suffers, because the numbers being reported drift away from what is actually happening inside the firm, potentially steering statement users toward the wrong conclusions (Dira & Astika, 2014).

Earnings Quality

As a construct, earnings quality gauges the degree to which the profit a company reports genuinely mirrors its financial performance and can be expected to hold up over time; it is on this basis that stakeholders form judgments about a firm's health and prospects (Wulansari, 2013). Alvin & Susanto (2022) frame it somewhat differently, describing earnings quality as the caliber of the profit information made available to the public - information that shapes decisions and that investors lean on when sizing up a company. When earnings are of high quality, they not only depict present-day operating results but also offer a useful basis for anticipating what lies ahead (Dechow & Schrand, 2004); they are characterized by the ability to predict future cash flows, consistency in accounting measurement, and freedom from manipulation. Razani & Xia (2017) add that high earnings quality reflects a company's financial health and accurately predicts its performance.

Profit Growth and Earnings Quality

Profit growth captures how a company's ability to increase net income relative to the previous year (Wahyuni *et al.*, 2017). A company that can grow its profit is generally considered to be in a safer position, and the earnings it generates are expected to be of higher quality in the future (Imaniyah & Maulita, 2021), partly because strong profit growth reduces the incentive to manipulate earnings. Imaniyah & Maulita (2021), Silaban & Harefa (2021), and Sumertiasih & Yasa (2022) find that profit growth positively affects earnings quality, whereas Abidin *et al.* (2022) and Anam & Afrohah (2020) find a negative effect, and Indrawati & Rahmawati (2023), Hakim & Naelufar (2020), and Lestari & Khafid (2021) find no effect. The first hypothesis of this study is stated as follows:

Ha₁: Profit growth affects earnings quality.

Profitability and Earnings Quality

Profitability refers to how much profit a firm is able to generate through its core operating activities (Hakim & Naelufar, 2020) and helps a company evaluate its ability to address financial problems, enabling faster and more appropriate decision-making (Noordiatmoko, 2020). Companies with high profitability tend to project a positive image to stakeholders and therefore have less need to manipulate earnings, which supports higher earnings quality. Anggraeni & Widati (2022), Indrawati & Rahmawati (2023), Sumertiasih & Yasa (2022) all report a positive relationship between profitability and earnings quality, Soly & Wijaya (2017) find a negative effect, while Nurlailia & Pertiwi (2020), Lestari & Khafid (2021), and Hakim & Naelufar (2020) find no effect. In view of these conflicting results, this study puts forward the following hypothesis:

Ha₂: Profitability affects earnings quality.

Liquidity and Earnings Quality

Liquidity is essentially a measure of how comfortably a firm can cover its short-term obligations (Indrawati & Rahmawati, 2023). A firm sitting on ample liquidity is under less financial strain, which should, in principle, leave management with a weaker motive to manage earnings and thereby help sustain earnings quality. Prior studies again point in different directions on this issue. Hasanuddin *et al.* (2021), Indrawati & Rahmawati (2023), and Lestari & Khafid (2021) report a positive effect of liquidity on earnings quality, Nurlailia & Pertiwi (2020) and Widiyanti *et al.* (2025) report a negative effect, while Anggraeni & Widati (2022), Hakim & Naelufar (2020) and Murniati (2019) report no effect. These divergent results motivate the third hypothesis:

Ha₃: Liquidity affects earnings quality.

Leverage and Earnings Quality

Leverage indicates the extent to which a company's operations are funded through debt rather than equity, essentially capturing the balance between liabilities and assets; firms that are financially healthy are typically expected to lean more on their own capital than on borrowed funds (Alvin and Susanto 2022). High leverage increases bankruptcy risk and creditor scrutiny, which can give managers an incentive to manage earnings in order to meet debt covenants and avoid violations, thereby reducing earnings quality. Lestari and Khafid (2021) report a positive effect of leverage on earnings quality, Alvin and Susanto (2022), Dewi *et al.* (2020), Yasa *et al.* (2020), and Purnamasari and Fachrurrozie (2020) report a negative effect, while Indrawati and Rahmawati (2023), Murniati (2019), and Nurlailia and Pertiwi (2020) report no effect. On the strength of this discussion, the fourth hypothesis is formulated as:

Ha₄: Leverage affects earnings quality.

Firm Size and Earnings Quality

Firm size refers to the scale of assets a company owns. Larger companies are generally trusted more by investors because they are considered to reflect stronger performance (Alvin & Susanto, 2022); they also tend to face closer scrutiny and have stronger incentives to report earnings accurately in order to avoid political and regulatory pressure, encouraging managers to think carefully before taking actions that could create conflicts of interest. Larger firms are therefore generally expected to exhibit higher earnings quality. Abidin *et al.* (2022), Alvin & Susanto (2022), Anam & Afrohah (2020), Maulia & Handojo (2022), and Purnamasari & Fachrurrozie (2020) find a positive effect of firm size on earnings quality, Helina & Permanasari (2017) and Indrawati & Rahmawati (2023) find a negative effect, while Hakim & Naelufar (2020), Nurlailia & Pertiwi (2020) and Soly & Wijaya (2017) find no effect. These conflicting results lead to the fifth hypothesis:

Ha₅: Firm size affects earnings quality.

Managerial Ownership and Earnings Quality

Managerial ownership denotes the share of company stock held directly by its managers or directors (Alvin & Susanto, 2022). It is thought to reduce agency problems because management holds a position comparable to that of shareholders as company owners (Hatane *et al.*, 2019), motivating agents to prefer undistorted information (Asfufi *et al.*, 2018). As managerial ownership rises, the gap between managers' and owners' interests is expected to shrink further, pushing managers to focus on building long-term firm value in ways that can lift earnings quality. Khafid & Arief (2017) report a positive effect, Yasa *et al.* (2020) find a negative effect, while Alvin & Susanto (2022), Dewi *et al.* (2020), Fathussalmi *et al.* (2019), and Soly & Wijaya (2017) find no effect. Taking these mixed results into account, the sixth hypothesis of this study is:

Ha₆: Managerial ownership affects earnings quality.

Institutional Ownership and Earnings Quality

Institutional ownership refers to the portion of a company's shares held by corporate entities rather than individuals, and it is often regarded as a benchmark pushing management to operate transparently, fairly, and accountably (Alvin & Susanto, 2022). Institutional ownership can strengthen oversight of management because institutions have the resources to monitor effectively, which can improve the reliability of financial reporting; a higher level of institutional ownership is generally linked to a lower probability of earnings management precisely because of this external monitoring, which can raise earnings quality. Amos *et al.* (2016) find a positive effect of institutional ownership on earnings quality, Tarmidi *et al.* (2023) find a negative effect, while Alvin & Susanto (2022), Kustono *et al.* (2021), and Maulia & Handojo (2022) find no effect. Building on this discussion, the seventh and final hypothesis is:

Ha₇: Institutional ownership affects earnings quality.

These seven hypotheses form the conceptual framework of the study, which is depicted graphically in Figure 1.

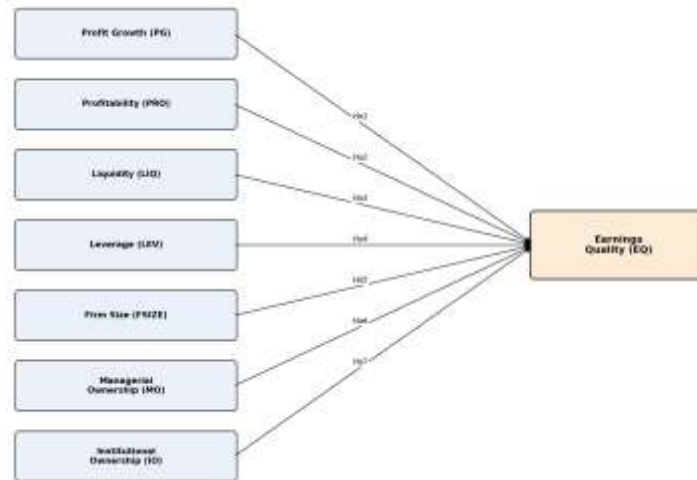


Figure 1. Conceptual Framework

METHODOLOGY

Sample Selection and Data Collection

This study draws its population from manufacturing firms listed on the Indonesia Stock Exchange (IDX) between 2021 and 2023, with financial-statement data gathered directly from the IDX website. Sample selection followed a purposive-sampling approach, and the resulting selection procedure is laid out in Table 1. Once outlying observations were removed, the usable sample comprised 91 companies, yielding 250 firm-year observations in total.

Table 1. Sample Selection Procedure

No.	Sample Criteria	Companies	Data
1.	Manufacturing companies consistently listed on the IDX from 2020-2024	237	711
2.	Manufacturing companies that did not consistently publish financial statements as of December 31 from 2020-2024	(9)	(27)
3.	Manufacturing companies that did not consistently use the Indonesian rupiah in their financial statements from 2020-2024	(37)	(111)
4.	Manufacturing companies that did not consistently generate profit from 2020-2023	(95)	(285)
5.	Manufacturing companies that did not consistently disclose institutional ownership from 2021-2023	(5)	(15)
	Total sample before outliers	91	273
	Outlier data		(23)
	Final research sample		250

Source: Data obtained from IDX and company financial statements

Operational Definition and Variable Measurement

Earnings Quality

In this study, earnings quality is understood as earnings that convey accurate information about a firm's current performance and genuinely reflect its profit (Laoli & Herawaty, 2019). Following Alvin & Susanto (2022), it is operationalized through accrual quality, computed as the standard deviation of the residuals obtained from the model below, which is estimated separately for each firm-year observation:

$$\begin{aligned} \frac{TA_{jt}}{Total\ Asset_{jt}} = & \beta_0 + \beta_1 \frac{CFO_{jt} - 1}{Total\ Asset_{jt}} \\ & + \beta_2 \frac{CFO_{jt}}{Total\ Asset_{jt}} + \beta_3 \frac{CFO_{jt+1}}{Total\ Asset_{jt}} \\ & + \beta_4 \frac{\Delta Sales_{jt}}{Total\ Asset_{jt}} + \beta_5 \frac{Fixed\ Asset_{jt+1}}{Total\ Asset_{jt}} \\ & + \beta_6 \frac{Book\ Value\ of\ Equity_{jt+1}}{Market\ Value\ of\ Equity_{jt}} + \varepsilon_{jt} \dots\dots\dots (1) \end{aligned}$$

where TA_{jt} is company j 's net income minus operating cash flow in year t ; CFO_{jt-1} , CFO_{jt} , and CFO_{jt+1} are operating cash flow in years $t-1$, t , and $t+1$; $\Delta Sales$ is the change in sales from year $t-1$ to year t ; $Fixed\ Asset_{jt+1}$ is fixed assets in year $t+1$; $Total\ Asset_{jt}$ is total assets in year t ; $Book\ Value\ of\ Equity$ is total equity in year $t+1$; and $Market\ Value\ of\ Equity$ is the stock market price multiplied by the number of shares outstanding in year t . The resulting residual standard deviation then serves as this study's proxy for earnings quality.

Profit Growth

Following Hakim & Naelufar (2020), profit growth is calculated as the year-on-year change in net income, i.e., the gap between the current and prior year's net income divided by prior-year net income:

$$Profit\ Growth = \frac{Current\ Year\ Net\ Income - Prior\ Year\ Net\ Income}{Prior\ Year\ Net\ Income}$$

Profitability

This study follows Indrawati & Rahmawati (2023), in measuring profitability through Return on Assets (ROA), defined as after-tax net income divided by total assets:

$$Profitability = \frac{Net\ Income}{Total\ Assets} \times 100\%$$

Liquidity

Liquidity is likewise measured following Indrawati & Rahmawati (2023), using the current ratio - current assets divided by current liabilities:

$$Liquidity = \frac{Current\ Assets}{Current\ Liabilities}$$

Leverage

Leverage is proxied by the Debt to Asset Ratio (DAR), computed as total debt over total assets, in line with Alvin & Susanto (2022):

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

Firm Size

As in Alvin & Susanto (2022), firm size is proxied by taking the natural logarithm of total assets:

$$\text{Firm Size} = \text{Natural Logarithm of Total Assets}$$

Managerial Ownership

Managerial ownership, following Alvin & Susanto (2022), is calculated as the proportion of total outstanding shares held by the firm's directors and commissioners:

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

Institutional Ownership

Institutional ownership follows Alvin & Susanto (2022), measured as the share of total outstanding stock held by institutional investors:

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

Data Analysis Method

This study uses multiple regression analysis at a 95% confidence level to test the hypotheses. The regression model is specified as follows:

$$EQ = \alpha + \beta_1(PG) + \beta_2(PRO) + \beta_3(LIQ) + \beta_4(LEV) + \beta_5(FSIZE) + \beta_6(MO) + \beta_7(IO) + \varepsilon$$

Here, EQ denotes earnings quality, α is the intercept, β_1 through β_7 are the coefficients to be estimated, and PG, PRO, LIQ, LEV, FSIZE, MO, and IO represent profit growth, profitability, liquidity, leverage, firm size, managerial ownership, and institutional ownership respectively, with ε representing the error term.

RESEARCH RESULT

Descriptive Statistics

The descriptive statistics for the 250 firm-year observations spanning 2021-2023 are summarized in Table 2. On average, earnings quality (EQ) stands at -0.003741, with a standard deviation of 0.0356610. Profit growth (PG) averages 0.632396 (SD = 2.3709963), while profitability (PRO) averages 8.264511 (SD = 5.7319243). For liquidity (LIQ), the mean is 2.704348 with a standard deviation of 1.9923387, and leverage (LEV) shows a mean of 0.372659 with a standard deviation of 0.1655197. Firm size (FSIZE), measured on a logarithmic scale, averages 29.233916 (SD = 1.5783461). Finally, managerial ownership (MO) has a mean of 2.795543 (SD = 5.8330352), and institutional ownership (IO) averages 72.578664, with a standard deviation of 15.1701389.

Table 2. Descriptive Statistics Results

Variable	N	Minimum	Maximum	Mean	Std. Deviation
EQ	250	-0.1228	0.1080	-0.003741	0.0356610
PG	250	-0.9734	22.1718	0.632396	2.3709963
PRO	250	0.0638	28.8101	8.264511	5.7319243
LIQ	250	0.5517	11.7556	2.704348	1.9923387
LEV	250	0.0427	0.8315	0.372659	0.1655197
FSIZE	250	25.1610	33.7306	29.233916	1.5783461
MO	250	0	31.7655	2.795543	5.8330352
IO	250	31.9293	99.4296	72.578664	15.1701389

Source: Processed data

Model Fit and Hypothesis Testing

The F-test yields a significance value of 0.000, well below the 0.05 threshold, confirming that the regression model as a whole is appropriately specified. Its Adjusted R Square of 0.338 further suggests that profit growth, profitability, liquidity, leverage, firm size, managerial ownership, and institutional ownership jointly account for 33.8 percent of the variation observed in earnings quality, leaving the remaining 66.2 percent to be explained by factors not captured in this model.

The t-test results, summarized in Table 3, show that profit growth (Sig. = 0.661 $\geq$ 0.05) and liquidity (Sig. = 0.280 $\geq$ 0.05) have no significant effect on earnings quality, so Ha1 and Ha3 are not supported. Profitability (Sig. = 0.000 < 0.05) has a significant positive coefficient on the residual standard deviation, which indicates a negative relationship with earnings quality, supporting Ha2. Leverage (Sig. = 0.009 < 0.05), firm size (Sig. = 0.002 < 0.05), managerial ownership (Sig. = 0.012 < 0.05), and institutional ownership (Sig. = 0.020 < 0.05) each have significant negative coefficients on the residual standard deviation, indicating a positive relationship with earnings quality, supporting Ha4, Ha5, Ha6, and Ha7.

Table 3. t-Test Results

Variable	B	Sig.	Conclusion
(Constant)	0.141	0.003	—
PG	0.000	0.661	Ha1 not supported
PRO	0.003	0.000	Ha2 supported
LIQ	-0.001	0.280	Ha3 not supported
LEV	-0.044	0.009	Ha4 supported
FSIZE	-0.004	0.002	Ha5 supported
MO	-0.001	0.012	Ha6 supported
IO	-0.000	0.020	Ha7 supported

Adj. R^2 = 0.338; F = 19.165; Sig. = 0.000. Source: Processed data

DISCUSSION

Profit growth does not affect earnings quality, consistent with Hakim & Naelufar (2020), Indrawati & Rahmawati (2023), and Lestari & Khafid (2021). An increase in net income does not necessarily indicate that a company avoids earnings manipulation, since profit growth can also result from non-operational gains or accounting choices that do not reflect sustainable performance. Liquidity likewise does not affect earnings quality, in line with Anggraeni & Widati (2022), Hakim & Naelufar (2020), and Murniati (2019), apparently, being able to cover short-term obligations does not, by itself, dampen management's motivation to manage earnings.

Profitability, on the other hand, exerts a significant negative effect on earnings quality, a result that mirrors Soly & Wijaya (2017). A strong profitability ratio is no guarantee that the earnings behind it truly reflect the firm's financial condition - such figures can just as well be the product of manipulation aimed at impressing investors. Firms enjoying high profitability may, for that reason, be more inclined toward earnings management, which ultimately drags earnings quality down.

Leverage is found to have a significant positive effect on earnings quality, consistent with Lestari & Khafid (2021). When debt is used effectively and efficiently, a company has a greater opportunity to generate profit and to meet its obligations from that profit. Reported earnings therefore reflect higher quality because they are less likely to result from earnings manipulation.

The positive and significant effect of firm size on earnings quality corroborates Alvin & Susanto (2022). Larger firms generally have more capacity both to sustain and to improve their financial condition, and they are correspondingly better positioned to steer clear of earnings management, which lifts earnings quality.

Managerial ownership similarly shows a significant positive effect on earnings quality, in agreement with Khafid & Arief (2017). By narrowing the gap between shareholders' interests and management's own, ownership stakes discourage managers from tampering with financial statements, thereby improving earnings quality.

Finally, institutional ownership exerts a significant positive effect on earnings quality, consistent with Amos *et al.* (2016). Share ownership by institutional shareholders discourages management from misusing company funds, since institutional shareholders have relatively independent interests from management and are motivated to exercise effective oversight and protect the interests of all shareholders. This reduces the likelihood of earnings management and ultimately improves earnings quality.

CONCLUSIONS AND RECOMMENDATIONS

Taken together, the findings indicate that profitability, leverage, firm size, managerial ownership, and institutional ownership each influence earnings quality among manufacturing companies listed on the Indonesia Stock Exchange over 2021-2023, whereas profit growth and liquidity show no such influence.

ADVANCED RESEARCH

A few limitations should be kept in mind when interpreting these results. The observation window is fairly short, spanning only three years (2021-2023); the population is confined to manufacturing companies listed on the IDX; heteroscedasticity was detected in the liquidity and leverage variables; and, with an Adjusted R Square of only 33.8 percent, the model's independent variables explain just a modest share of the variation in earnings quality.

Subsequent studies could address these gaps by lengthening the observation period to around five years so as to better capture long-run effects, widening the population to cover all IDX-listed companies rather than manufacturing firms alone, applying a data transformation such as a logarithmic transformation to correct for heteroscedasticity, and incorporating additional predictors - financial distress, tax avoidance, audit committee characteristics, or the investment opportunity set, among others - that may further help explain earnings quality.

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