Determinants of earnings quality: An empirical study in Indonesia

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Abstract

This study aims to investigate the factors that influence the quality of earnings. In this study, there are three independent variables: capital structure, investment opportunity set, and information asymmetries. Earnings quality is proxied by discretionary accruals. Capital structure will be expressed as a ratio of debt to equity. Investment opportunity set is measured by comparing market value with book value. Information asymmetries are quantified using the bid-ask spread. The research population is manufacturing sector. The method of determining a sample using purposive sampling. Research samples that met the criteria were obtained as many as 160 firms years. The analysis tool uses multiple linear regression analysis methods. The results of the study show that capital structure and asymmetric information have a positive effect on earnings quality. Meanwhile, the investment opportunity set has no effect on earnings quality. The results of this study also have practical implications for investors, particularly in terms of providing information on the factors that influence earnings quality, which can be used as a basis for investment decisions.

Keywords: Capital Structure; Earnings Quality; Information Asymmetry; Investment Opportunity Set.

Abstrak

Penelitian ini bertujuan untuk menganalisis faktor-faktor yang memengaruhi kualitas laba. Penelitian ini memiliki kontribusi dalam memperkaya literatur empiris khususnya pada rumpun ilmu akuntansi keuangan. Tiga variabel independen dalam penelitian ini adalah struktur modal, investment opportunity set dan asimetri informasi. Kualitas laba diproksi dengan akrual diskresioner. Struktur modal akan dinyatakan dalam rasio utang dan rasio ekuitas. Investment opportunity set diukur dengan membandingkan nilai pasar dengan nilai buku. Pengukuran informasi asimetri dengan bid-ask spread. Populasi penelitian menggunakan industri manufaktur. Teknik penentuan sampel menggunakan teknik purposive sampling. Sampel penelitian yang memenuhi kriteria didapatkan sebanyak 160 tahun perusahaan. Alat analisis menggunakan metode analisis regresi linier berganda. Hasil penelitian menunjukkan bahwa struktur modal dan informasi asimateri berpengaruh positif terhadap kualitas laba. Sedangkan investment opportunity set tidak memiliki pengaruh terhadap kualitas laba. Hasil penelitian ini juga memiliki implikasi secara praktis bagi investor terutama dalam memberikan informasi terkait dengan faktor-faktor yang mempengaruhi kualitas laba sehingga dapat dijadikan dasar pertimbangan keputusan investasi.

Kata Kunci: Asimetri Informasi; Investment Opportunity Set; Kualitas Laba; Struktur Modal.

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INTRODUCTION

Various types of information are provided by entities to outside parties. Information about profitability is one of the things that is offered. When making investment decisions or assessing an organization's operational effectiveness, information about earnings is crucial information from financial reports. Every entity competes to raise its profit to attract investors due to the relevance of profit information for its users (Simamora et al., 2014). If an entity generates consistent and reliable profits, it is said to have high-quality earnings. Quality earnings, as defined by the accrual component and cash flow, are profits that potentially reflect sustainable earnings in the future (Penman, 2001). Transparent reported earnings will be exhibited by entities with excellent earnings quality (Risdawaty & Subowo, 2015). In the meantime, entities with poor earnings alter the prepared financial statements by inflating the profit amount to suit the needs of the entity's management. This is true since the management of the entity, who oversees its activities, is not the entity's owner (Risdawaty & Subowo, 2015).

In managing entities, entity owners tend to appoint agents (managers) to carry out entity operations so that managers as internal entities have more information about entity conditions than external parties, in accordance with agency theory. According to Eisenhardt (1989), three assumptions about human nature are used in agency theory. Humans only have their own interests in mind (self-interest), their ability to predict the future is constrained (bounded rationality), and they dislike danger (risk averse). Assuming that managers are inherently opportunistic, they will prioritize their own interests over those of the company, which will result in agency conflict (Mahawyahrti & Budiasih, 2016). Focusing on objectives that need to be congruent or at odds with one another leads to conflicts amongst stakeholders (Rahmat et al., 2020). The development of asymmetrical information between management and outside organizations is encouraged by agency difficulties (Reyhan et al., 2014). While management prefers to receive high compensation for their performance, principals typically want their businesses to remain operational (going concerns) and to maximize the return on their investments (Arisonda, 2018). Users who receive low-quality compensation may make poor decisions (Helina & Permanasari, 2017). Agency issues specifically result from disparate interests of the two parties in a corporate partnership (Septiyani et al., 2017). Agency theory suggests that these issues can be resolved by utilizing earnings quality as a metric for evaluating the caliber of financial information (Sadiah & Patuh, 2015).

Earnings quality can be influenced by a number of things. This study hypothesizes that earnings quality is influenced by capital structure, investment opportunity set, and information asymmetry. The capital structure is a description of the funding source for a corporation, which is equity (shareholders' equity), and where the company's capital comes from. If an entity's assets are financed by liabilities rather than capital, investors will not be interested in investing. Managers falsify data as a result to produce low-quality revenues (Sukmawati et al., 2014). According to Sadiah & Patuh (2015) and Marisatusholekha & Budiono (2015), capital structure has no effect on quality earnings. An opportunity for a company to expand is known as an investment opportunity set (IOS). Managers will disclose low-quality earnings if an entity has a low IOS value. Entity managers will tamper with financial data to keep the business growing (Novianti, 2012). Research by Simamora et al. (2014) and Nurhanifah & Jaya (2014), in contrast, discovered that the investment opportunity set (IOS) has no impact on the caliber of earnings.

Information asymmetry is a condition when the manager has access to information on the prospects of an entity that is not owned by an external entity. If the information asymmetry in the entity is high, it will produce low quality earnings. Earnings quality, thus, is a measure of the extent of information asymmetry between managers and investors caused by reporting or accounting distortions (Beyer et al., 2019). This is because the manager as a party who knows more about the state of the entity will hide some information that is not known by the principal (Lisa, 2012). The opposite was conveyed by Firdaus (2013) that information asymmetry has no significant effect on earnings management. Barus & Setiawati (2015) also stated that information asymmetry has no significant impact on earnings management. The results of Lahaya & Kurniawan's research (2016) found that information asymmetry positively affects earnings quality. Meanwhile, study conducted by Risdawaty & Subowo (2015) and Reyhan et al. (2014) found that information asymmetry did not affect earnings quality.

The importance of profit information for external parties results in managers as internal entities ignoring good business practices (Sadiah & Patuh, 2015). Financial Accounting Standards (SAK) allow entities to choose the accounting method used in preparing financial reports. The application of the accrual concept has the potential to trigger management to engineer financial reports by increasing or decreasing the accrual numbers in the income statement, which will affect the quality of the profit generated (Rachmawati & Triatmoko, 2007). If the entity manager reports earnings that do not reflect the actual condition of the entity, it will result in low earnings quality.

The low quality of earnings will harm users, such as investors and creditors. Profits that do not show accurate information about management performance can mislead users (Warianto & Rusiti, 2014).

This study contributes to the literature by examining the impact of capital structure, the level of the investment opportunity set, and information asymmetry as conditions that represent a more comprehensive range of opportunities for earnings management practices. The results of this study will be useful for investors to understand reported earnings better. Investors should not naively use accounting income figures without adjustments for possible manipulation of reported earnings. Accounting standard setters may find the results of this study useful for evaluating mandated additional disclosures that provide sufficient information for a better understanding of reported earnings. Deviations from the function of financial reports that should be a guide for investors in making business decisions mislead and harm these investors (Risdawaty & Subowo, 2015).

LITERATURE REVIEW

Earnings Quality

A market response to earnings information can be shown by a variety of responses to published financial report. The response is based on how well the entity's profit is produced. The responsiveness of earnings information to the market might be interpreted as an indicator of earnings quality. Earnings quality encompasses understatement and overstatement of net earnings, stability of components in the income statement, and realization of asset risk rather than being tied to high or low reported earnings (Reyhan et al., 2014). The ability to accurately reflect the entity's current operating performance, the ability to give a solid predictor of the entity's success in the future, and the ability to be a good metric to assess entity performance are three qualities of quality earnings (Dechow & Schrand, 2004).

Earnings Quality is earning that reflects sustainable earnings in the future and shows the actual financial performance of the entity (Sadiah & Patuh, 2015). In addition, earnings quality do not contain perceived noise. Perceived disturbances in accounting earnings are caused by transitory events or the application of the concept of accruals in accounting. Perceptual disturbances include manipulating accrual accounts by adhering to standards that can reduce or increase these accrual accounts so that they can affect reporting of entity profits (Murniati et al., 2018). Accrued earnings may be of lower quality than cash flows because accrual earnings can be manipulated. The decomposition of earnings into disaggregated cash flows and accruals allows a much more accurate description of future operating cash flows (Noury et al., 2020). In Situmorang (2017), the factors influencing earnings quality are liquidity, size, capital structure, and investment opportunity set. Mahawyahrti & Budiasih (2016) show another factor affecting earnings quality: information asymmetry. When the information asymmetry of the manager is higher than that of the entity's external parties, it will encourage entities to manipulate financial reports so that the quality of the resulting profit is low.

Earnings quality is an indicator of the quality of financial information (Helina & Permanasari, 2017). Profit is used by external parties as an indicator to measure the operational performance of the entity. If an entity's earnings is low, it will make decision-making mistakes for users, such as investors and creditors. Profits that do not show true information about management performance can mislead users (Simamora et al., 2014). The low quality of earnings will bias the decisions made by users of financial statements. Investors will use the entity's past earnings information to assess the entity's prospects in the future. Therefore, the profit reflected in the financial statements must be of quality, namely relevant and reliable, so that they can be helpful for decision-makers (Soly & Wijaya, 2017).

Capital Structure on Earnings Quality

The entity's capital structure affects the quality of earnings because investor interest will decline if the entity's assets are financed more by liabilities than by capital. This is because it is thought that the entity cannot maintain a financial equilibrium in the usage of funds between the quantity of capital that is available and the amount of capital that is needed (Sukmawati et al., 2014). Suppose a company has a high degree of leverage. In that instance, it will likely have a propensity to falsify data to produce low-quality profits for the company (Situmorang, 2017). This is due to the fact that companies with a high liability level also have a high financial risk, including the potential for the company to be unable to pay its debts and the uncertainty generating profits in the future. As a result, large levels of debt will motivate managers to distort financial reports, resulting in low-quality results (Savitri et al., 2014). The research results of Lia (2018) and Warianto & Rusiti (2014) provide empirical evidence that capital structure affects earnings quality.

H_1: Capital structure has a negative effect on earnings quality.

Investment Opportunity Set on Earnings Quality

Investment Opportunity Set is the present value of the entity's decision to make investments in the future and represents the investment opportunity value. The quality of earnings created will be impacted if the management takes a decision that is contrary to the principle's wishes because there has been an agency conflict—a divergence in the interests of the agent and the principal (Simamora et al., 2014). The investment opportunity set is the basis for determining the classification of an entity's growth in the future, whether an entity is classified as growing or not. (Nurhanifah & Jaya, 2014). High growth companies are frequently referred to as having abundant investment prospects. This encourages managerial parties to make significant reinvestments. The future expansion of the business is forecast using IOS. Future discretionary spending determines IOS's worth (Kallapur & Trombley, 1999). IOS can also affect how managers, owners, investors and creditors view the company. Companies that have high growth opportunities are considered capable of generating high returns. Riyani et al (2020) stated that a high IOS is directly proportional to discretionary accruals. IOS and discretionary accruals show that managers of firms with high investment opportunities tend to manipulate discretionary accruals so that earnings quality is low. When an entity has a high investment opportunity set, the entity's value will increase because it attracts many investors to invest in the hope of obtaining a greater return in the future.

The results of research Arisonda (2018) and Murniati et al. (2018) regarding the effect of the investment opportunity set on earnings quality found that the investment opportunity set has a negative effect on earnings quality. If the investment opportunity set in a high entity tends to be positively assessed by investors because it has more profit prospects (Situmorang, 2017).

H_2: Investment Opportunity Set has a positive effect on earnings quality.

Information Asymmetry on Earnings Quality

Information asymmetry arises from information gaps due to conflicts of interest between managers, shareholders, and other stakeholders. The existence of information asymmetry causes investors to be unable to make optimal decisions because investors are faced with problems of unclear risks and benefits of their investments (Lahaya & Kurniawan, 2016). Earnings quality is low if the entity has high information asymmetry. This is because the existence of information asymmetry owned by management will encourage management to engineer financial reports so that the resulting profit information will be of low quality (Reyhan et al., 2014).

H_3: Information asymmetry has a negative effect on earnings quality.

METHODS

Research Design

This study conducts archival data collection. Information is gathered from companies that are listed on the Indonesian Stock Exchange. Time series data from 2016 to 2019 are the specific type of research data. The characteristics of the data used are quantitative data, or data or information collected from sources in the form of numerical data, such as financial reports. Secondary data, or information that has already been received or gathered, is the type of data used in this study. Four criteria were employed in the purposive sampling method to choose the sample. First, the business is a part of the manufacturing sector. The second is that it has a positive profit during the year of research. Third, publish public financial reports. Fourth, the information required for study is available. 40 firm samples were obtained based on these criteria in a single year, making the total sample 160 company years.

Definition and Measurement of Variables

The dependent variable of this study is earnings quality as measured by discretionary accruals. Discretionary accruals are estimated using normal accruals expected of total accounting accruals. Expected accounting accruals are estimated using a cross-sectional approach. The measure of accounting accrual expectations uses a modified model (Jones, 1991). The independent variables in this study are capital structure, investment opportunity set (IOS), and information asymmetry. Capital structure will be expressed in terms of debt ratio and equity ratio. IOS shows a company's investment decisions and also the company's opportunities to grow and as a basis for determining the classification of future growth. IOS is measured by a market-to-book value of assets ratio (MVA/BVA). Measurement of information asymmetry uses the bid-ask spread. Linear regression testing uses model (1).

$$EQ = \alpha + \beta_1 CS + \beta_2 IOS + \beta_3 IA + \varepsilon \quad (1)$$

EQ is earnings quality, CS is capital structure, IOS is investment opportunity set, and IA is information asymmetry.

RESULTS AND DISCUSSION

Data Analysis

Table 1 displays the empirical outcomes of data analysis utilizing multiple regression analysis. Based on Table 1, the F test's sig value is 0,000, indicating that the simultaneous effects of capital structure, investment opportunity set, and information asymmetry on earnings quality. The RSquare value after adjustment is 0,112. A satisfactory test result is indicated by an adjusted RSquare positive number. It can be said that the dependent variable may be explained or predicted by 11,23% of the independent variables.

The results reveal a constant value of 0,262, indicating that the earnings quality (EQ) is 0,262 if the variables for capital structure (CS), investment opportunity set (IOS), and information asymmetry (IA) are all 0. Given that the Earnings Quality has a positive value of 1,007 and a positive regression coefficient on the variable capital structure, an increase in earnings quality will occur for every unit increase in capital structure. The regression coefficient on the variable information asymmetry has a positive value on earnings quality, which is 0,013, meaning that an increase on information asymmetry of 1 will be followed by increasing in earnings quality of 0,013.

Table 1. Results of Regression Analysis

Variable	B	t	Sig
(*Constant*)	0,262	1,299	0,202
SM	1,007	2,447	0,019
IOS	-0,022	-0,516	0,609
IS	0,013	4,715	0,000
N	160		
F	0,000		
Adjusted R^2	0,112		

Source: Processed data, 2022

Hypothesis Testing

The significance test is used to determine whether capital structure, investment opportunity set, and information asymmetry have a significant effect on earnings quality. Based on the Table of significance test results, the value can be calculated, it is 2,028 (df = 0,05/2 ; n(40) - k(3) - 1 = 0,025 ; 36). Capital structure on earnings quality, has a significant level of 0,019, less than 0,05 and a   value of 2,447 > 2,028 means that capital structure has a positive influence on earnings quality. Investment opportunity set on earnings quality, has a significant level of 0,609 greater than 0,05, and the value -0,516 < 2,028 means investment opportunity set does not affect the quality of earnings. Information asymmetry on earnings quality has a significant level of 0,000 less than 0,05, and a value of 4,715 > 2,028 means that information asymmetry has a positive effect on earnings quality.

Effect of Capital Structure on Earnings Quality

Based on the test results from multiple linear regression analysis, the capital structure variable on earnings quality evaluated by leverage has a significant value. The presented hypothesis is accepted since it can be inferred from the statistical findings that capital structure has a significant impact on discretionary accruals (decreasing earnings quality). The likelihood of an entity being unable to pay its liabilities and uncertainty over generating earnings in the future mean that entities with a high level of liability can have an influence on financial risk that is even bigger. Therefore, when an entity's level of leverage is high, its earnings quality is lower because entity managers are motivated to manipulate financial statements to maintain the entity's financial balance so that the reported earnings has low quality. This study's results align with research conducted by Puspita Lia (2018) and Warianto & Rusiti (2014), which state that capital structure affects earnings quality. This study's results differ from research conducted by Marisatusholekha & Budiono (2015) and Sadiah & Patuh (2015), which state that capital structure does not affect earnings quality.

Effect of Investment Opportunity Set on Earnings Quality

Based on the statistical results, it can be explained that the investment opportunity set has no effect on earnings quality, so the proposed hypothesis is rejected. Investment opportunities do not directly affect the quality of earnings. This can be influenced by the total assets of a company or come from internal company factors. Internal factors can be caused by unobservable actions of managers, which cause principals to be unable to know whether the actions taken by management are in accordance with the principal's wishes. Unknown actions by the principal may allow management to act freely and without the principal's consent, allowing management to engage in manipulations that may lower the quality of the company's earnings. The results of this study are in line with research conducted by Simamora et al. (2014) and Nurhanifah & Jaya (2014), which state that the investment opportunity set has no effect on earnings quality. The results of this study differ from research conducted by Arisonda (2018) and Murniati et al. (2018), which state that the investment opportunity set influences earnings quality.

Effect of Information Asymmetry on Earnings Quality

Based on multiple linear regression analysis testing, information asymmetry positively affects discretionary accruals, so the proposed hypothesis is accepted. If an entity has a high level of information asymmetry, the earnings quality is low. This is because the manager, as an internal entity party, knows more about the actual condition of the entity than external parties. In running the entity, the manager is not the entity's owner, resulting in a conflict of interest. Agency theory implies the existence of information asymmetry between the agent and the principal. When asymmetry is high, stakeholders need more resources for relevant information in monitoring the actions of managers so that the information asymmetry owned by managers will encourage managers to engineer financial reports. This causes the quality of reported earnings is low because investors cannot make optimal decisions; as a result, investors are faced with unclear risks and benefits of their investment. This study's results align with research conducted by Lahaya & Kurniawan (2016), which states that information asymmetry influences earnings quality. This study's results differ from research conducted by Risdawaty & Subowo (2015) and Reyhan et al. (2014), which state that information asymmetry does not affect earnings quality.

CONCLUSION

Capital structure has a positive effect on earnings quality. This is because entities with a high liability level will have a significant financial risk, namely the possibility of default risk, which causes uncertainty in generating future profits. This will encourage managers to engineer financial statements to overcome these problems so that the quality of the reported earnings is low. Investment opportunity set does not affect earnings quality. This is because the value of the investment opportunity set is less the center of attention of investors. After all, investors pay more attention to profit figures for entities. Investors tend to invest to gain short-term profits (capital gains) and not long-term gains. Information asymmetry has a positive effect on earnings quality. This is because managers, as internal parties of the company, know more about the actual condition of the entity than external parties of the entity. Because in running the entity, the manager is not the entity's owner, agency conflicts occur in accordance with agency theory. Thus, the information asymmetry owned by managers will encourage managers to manipulate financial statements, which can cause the quality of the resulting earnings to be of low quality and can mislead decision-makers.

The quality of earnings is positively impacted by capital structure. This is due to the fact that businesses with a high level of liability will face significant financial risk, specifically the risk of default, which makes it difficult to predict how much profit will be made in the future. This will motivate managers to do financial statements engineering to get around these issues, resulting in low-quality reported earnings. The investment opportunity set does not affect earnings quality. It is caused by investors's attention less focused on the investment opportunity set's value, and more interested in entity's earnings numbers. Investors typically invest in order to realize short-term gain (capital gains), rather than long term gain. The quality of profits is positively impacted by information asymmetry. This is due to the fact that managers, as internal parties of the organization, are more familiar with the actual state of the entity than are external parties. Agency conflicts arise in accordance with agency theory since the manager is not the entity's owner when managing the entity. As a result, the information asymmetry that managers control will motivate managers to alter financial statements, which could lead to low-quality earnings that could mislead decision-makers.

This study has limitations in the number of independent variables used, which are only capital structure, investment opportunity set, and information asymmetry. In addition to the independent variables included in this study, it is intended that future research would add more independent variables that are believed to affect earnings quality. Additionally, it may calculate earnings quality using different proxies and compare them to see which one is best for precisely explaining earnings quality. This broadens the scope of study objects beyond the manufacturing industry.

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