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The influence of profitability, company size, and the audit committee on earnings quality

Annastasia Magdalena, Rahmiati, M. Ichsan Diarsyad
Faculty of Economics and Business, Universitas Pamulang
*E-mail: annastasiamadln@gmail.com

ARTICLE HISTORY	*ABSTRACT*
Received: July, 31st 2024 *Revised: August, 15th 2024* *Accepted : September, 25th 2024* ***Keywords :*** *earnings quality* *firm size* *profitability*	*This study aims to provide an empirical explanation of the effect of profitability, company size and audit committee on earnings quality. This study uses quantitative descriptive research with secondary data in the form of annual financial reports of food and beverage companies listed on the Indonesia Stock Exchange for the period 2018-2022. The sample selection used purposive sampling, and the number of samples used was 115 samples, and the analysis tool used was Statistical Product and Service Solutions (SPSS) 26. The analysis techniques used are descriptive analysis and multiple linear regression analysis. The results of the research indicate that profitability has no effect on earnings quality; 2) company size has no effect on earnings quality; 3) audit committee has a positive and significant effect on earnings quality; and 4) profitability, company size and audit committee simultaneously affect earnings quality.*

INTRODUCTION

When establishing a company, goals and targets are to be achieved, such as maximizing profit. Profit is a critical element of financial report that stakeholders heavily consider in decision-making processes. Consequently, managers often choose different methods to present financial statements. Financial statements contain essential information from the accounting process analysis, aiming to assess the company’s financial position and measure business performance. These reports are crucial for management to evaluate the outcomes of the company's operational activities. Management typically has more comprehensive knowledge about the company than shareholders, which can lead to managerial behaviours such as financial statement manipulation. Financial statement manipulation refers to management's interference in preparing reports to gain personal benefits, implying that profit manipulation practices can lower earnings quality.

Earnings quality is essential for financial statement users, particularly those seeking high-quality earnings. Consistent and stable profits characterize companies with high-quality earnings. Companies with such earnings transparency tend to report their profits openly. The size of a company is often reflected by its value, which is related to earnings quality. As a company grows, its financial performance improves, reducing the likelihood of profit manipulation. Larger companies tend to attract capital more easily, which marks the beginning of business growth. Investors respond positively to companies showing improved profitability, which indicates future profit potential. Previous studies found that firm size positively impacts earnings quality (Wijaya, 2020; Zatira et al., 2021).

Secondly, audit committees oversee and improve the effectiveness of transparency and financial information quality. An effective audit committee ensures better control over the company, minimizing management's opportunistic behaviour to enhance personal welfare. The audit committee plays a critical role as it influences a company's earnings quality, which is vital information for the public and investors in assessing the company's value. This aligns with research before which found a positive and significant relationship between the audit committee and earnings quality (Bawoni & Shodiq, 2020; Novrianti & Isynuwardhana, 2024; Pujiati & Nita, 2022). On the other hand that the audit committee has no impact on earnings quality (Widmasari et al., 2019).

Thirdly, profitability reflects a company's ability to generate profits. Earnings are considered high-quality when the company consistently produces optimal profitability and provides accurate information. Profitability is a core aspect of performance evaluation, as it reflects a company's ability to meet obligations, helps investors make informed decisions, and projects the company's future prospects. Higher profitability attracts investors to the company. Research befor confirmed a positive impact of profitability on earnings quality (Purnamasari & Fachrurrozie, 2020; Santoso, 2020), while other research found no effect (Hakim & Naelufar, 2020).

Manufacturing companies contribute significantly to economic growth, especially in the food and beverage subsector. This sector remains promising as the demand for food and beverages grows as basic human needs. Additionally, this sector attracts substantial investor interest due to its resilience during economic downturns, as demonstrated by its survival in challenging Indonesian economic conditions. The Minister of Industry, Agus Gumiwang Kartasasmita, stated on September 9, 2022, that despite the COVID-19 pandemic, the food and beverage industry showed resilience with a 3.68% growth in Q2 2022, compared to 2.95% in the same period in 2021. The sector also contributed 38.38% to the non-oil and gas GDP, making it the largest contributor to Indonesia's GDP. In the same period, exports reached USD 21.3 billion, up 9% from USD 19.5 billion in 2021. Moreover, the sector attracted investments worth IDR 21.9 trillion by Q2 2022 and employed 1.1 million people.

However, cases like PT Tiga Pilar Sejahtera Food Tbk (AISA), where earnings quality declined due to inaccurate profit reporting, highlight the importance of maintaining and improving earnings quality. Two former directors of PT Tiga Pilar Sejahtera Food Tbk (AISA), Stefanus Joko Mogoginta and Budhi Istanto, were sentenced to seven years in prison for financial statement manipulation. This emphasizes the need for companies to evaluate and improve their earnings quality to attract more investors.

This study builds upon research on the influence of capital structure, firm size, liquidity, and audit committees on earnings quality in manufacturing companies listed on the Indonesia Stock Exchange from 2014-2018 (Azizah et al., 2020). The research gap addressed in this study includes adding profitability as an independent variable and focusing on the food and beverage subsector during 2018-2022 to reflect current developments.

LITERATURE REVIEW

Agency Theory

Agency theory describes the relationship between a principal (owner) and an agent (manager). This theory is fundamentally based on the connection between ownership (principal) and management (agent) (Jensen & Meckling, 2019). The principal holds the authority to direct the company through the agent, while the agent represents the personnel tasked with mediating the principal's interests and the other stakeholders.

In agency theory, the separation between ownership and management can lead to conflicts, known as agency conflicts. These conflicts arise because both the principal (the one who provides the contract or shareholders) and the agent (the one who receives the contract and manages partial funds) hold important yet often opposing roles. Agency theory assumes that individuals are motivated by their self-interests, which can lead to conflict. Agents and principals have different objectives, each seeking to fulfil their goals, leading to conflicts of interest. Shareholders desire higher returns on investments as quickly as possible, while managers often focus on their personal benefits, such as securing higher compensation.

This information gap, known as information asymmetry, can prompt managers to manipulate earnings to serve their own interests. As a result, reported earnings may not accurately reflect the company's true performance, misleading financial statement users. Agency theory provides mechanisms to minimize conflicts between the differing interests of the principal and agent, offering solutions to align their goals and reduce tensions.

Profitability

Profitability represents a company's ability to generate profits from its activities, such as sales, cash flow, and capital. It is a key measure to assess the company's sustainability and is a vital indicator of its performance (Hakim & Naelufar, 2020). Without profitability, a company may struggle to attract external capital. Profitability reflects a firm's capacity to generate income over a specific period (Tobibah & Firmansyah, 2024). Higher profitability is often associated with attracting more investors, making the company a more appealing investment opportunity.

Research before found that profitability does not significantly impact earnings quality (Hakim & Naelufar, 2020). However, profitability indicates a company's ability to generate profit over time (Rosady, 2022). A company's profitability optimizes its value, reflected in rising stock prices in the market. As profitability improves, it signals better company performance, attracting investors who perceive it as a promising investment for the future. Return on Assets (ROA) is used to measure the effectiveness of a company in managing assets, whether through internal funds or external loans (Abbas et al., 2022). This study measures profitability using the Return on Assets (ROA) ratio, which illustrates the return on the total assets used within the company.

Company Size

Company size refers to a firm's classification based on its scale of operations and revenue generation (Hasanuddin et al., 2021; Margono & Gantino, 2021). Larger companies often have more stable operations and can manage their finances more effectively, including tax avoidance through available legal loopholes (Damayanti et al., 2020). Growing companies are more likely to attract capital, as their profit information positively influences investor sentiment. When a company reports higher profits, investors react favourably because they believe the company will provide future returns. In this study, company size is measured using the natural logarithm (Ln) of total assets. This method helps normalize data, reducing the risk of extreme values due to significant differences in asset sizes between companies (Hakim & Abbas, 2019).

Audit Committee

The audit committee is an integral part of corporate governance, mandated for large or publicly listed companies. Its role includes overseeing financial reporting, monitoring internal control systems, and ensuring that accounting standards are followed (Napitupulu, 2023). The audit committee plays a critical role in maintaining internal control within a company, and the effectiveness of this committee can significantly impact earnings quality.

The audit committee consists of one or more members of the board of commissioners and may include external experts, Utami. Its primary function is to maintain transparency in financial reporting, ensure fairness to stakeholders, and disclose all relevant information, even in the presence of conflicting interests. In this study, the audit committee variable is calculated by the number of members.

Earnings Quality

Earnings quality focuses on the accuracy and reliability of reported earnings. High-quality earnings reflect a company’s actual financial performance and are critical for making sound decisions (Saleh et al., 2020). High-quality earnings have characteristics such as relevance, understandability, reliability, and decision-usefulness (Elsiddig Ahmed, 2020).

A company’s management, having more information about the firm than external parties, may engage in earnings management, which reduces the quality of reported earnings (Palacios-Manzano et al., 2021). Low-quality earnings indicate poor resource allocation and operational inefficiencies (Tahat et al., 2022). Earnings quality can be assessed through various qualitative and quantitative methods, including accrual persistence and cash flow predictability (Menicucci & Menicucci, 2020).

METHODS

This research is a type of quantitative descriptive research, which collects data and analyzes it to determine whether the formulated hypothesis is proven or not (Sugiyono, 2017). The purpose of quantitative research is to develop and use mathematical models, theories, or hypotheses related to a phenomenon. This research is quantitative, where data is collected and analyzed to test the hypothesis (Sugiyono, 2017). The company's financial reports were obtained from the Indonesia Stock Exchange (IDX) website. The research design falls under causal research, which aims to prove the cause-effect relationship between independent and dependent variables or how one variable influences another. The data used include financial reports such as income statements, financial position reports, and cash flow statements, which are analyzed using SPSS 26.

The data source for this research is secondary data, obtained indirectly from other sources, namely financial reports and annual reports of the food and beverage subsector for the period 2018-2022, accessed through the Indonesia Stock Exchange or the website www.idx.co.id. The population in this study consists of food and beverage subsector companies listed on the Indonesia Stock Exchange from 2018 to 2022. There are 31 companies registered on the IDX as of 2022. The sample is defined as part of the total and characteristics of the population. If the population is large, researchers may find it difficult to understand everything within it. The sampling method is purposive sampling, which selects samples based on the completeness of data and specific criteria. The selected sample is based on the following criteria food and beverage subsector companies listed on the IDX from 2018 to 2022, companies that did not consistently publish financial reports on the IDX from 2018 to 2022, food and beverage subsector companies using Indonesian Rupiah as their currency, food and beverage subsector companies that did not continuously suffer losses from 2018 to 2022.

The data collection technique in this study is non-participant observation, which involves observing, recording, and downloading the required data from documents accessed through www.idx.co.id using purposive sampling in the food and beverage subsector on the IDX for the period 2018-2022. The data analysis method used in this study is quantitative data analysis, where the research is conducted with a quantitative approach using statistical tools. Raw data requires processing to be used in further analysis. The analysis is conducted in two stages: preliminary analysis and hypothesis analysis. Data processing and hypothesis testing in this research utilize several statistical tests, including regression models processed using Statistical Product and Service Solution (SPSS) 26.

Descriptive statistics provide illustrations or descriptions of data seen through mean values, standard deviations, variance, maximum, minimum, sum, range, kurtosis, and skewness (distribution skewness). Thus, the researcher concludes that descriptive statistics are used to summarize the accumulated data to present a general picture of the research object using statistical measurements. The variables used in this study include profitability, capital structure, company size, and the audit committee, which will be summarized in statistical measures (Ghozali, 2016).

Hypothesis testing is a decision-making method based on data analysis, either from controlled experiments or observations. Hypothesis testing is often referred to as confirmatory data analysis. The decision from hypothesis testing is typically based on testing the null hypothesis. In this study, the data analysis method used to test the research hypothesis is multiple linear regression analysis, which examines the relationship between one dependent variable and two or more independent variables. Data is processed using SPSS software.

Coefficient of determination (R^2) measures how well the model explains the variation of the dependent variable. An R^2 value close to one indicates that the independent variables provide almost all the information needed to predict the variation of the dependent variable. The F-test is used to assess the overall significance of the effect of multiple independent variables on the dependent variable simultaneously. The t-test measures the effect of one independent variable on the dependent variable, determining whether it significantly explains the variation of the dependent variable.

RESEARCH RESULT

The Influence of Profitability on Earnings Quality

Profitability, measured by Return on Assets (ROA), reflects a company's ability to generate profit through asset management. Although basic theory suggests that high profitability indicates high-quality earnings, the research shows otherwise. Profitability does not always reflect high earnings quality because companies with high profitability may engage in earnings management practices, which undermines the trust in financial reports. In other words, high profitability does not necessarily represent true earnings quality, as high-quality earnings should reflect the company's actual financial performance.

The Influence of Company Size on Earnings Quality

Company size is often associated with stability and management's ability to manage assets effectively. However, this research found that company size does not affect earnings quality. Although large companies have more resources and are considered more attractive to investors, this does not directly reflect high-quality earnings. This indicates that company size is not the main indicator of earnings quality, as good financial performance is more dependent on proper managerial practices rather than the size of the company.

The Influence of the Audit Committee on Earnings Quality

The audit committee plays a key role in ensuring the accuracy of financial reports as part of corporate governance. This study confirms that the audit committee has a significant influence on earnings quality. With effective oversight by the audit committee, the transparency of financial reports can be ensured, thereby increasing the quality of the reported earnings. This aligns with agency theory, which emphasizes the importance of the audit committee in overseeing management to prevent conflicts of interest and earnings manipulation.

Simultaneous Influence

Simultaneously, profitability, company size, and the audit committee have a significant influence on earnings quality. This aligns with agency theory, which explains that profitability and company size provide investors with confidence in the company's ability to generate earnings, while the audit committee ensures the accuracy of financial reports. These three variables support each other in creating high-quality and accountable financial reports. This study concludes that while profitability and company size individually do not significantly impact earnings quality, effective supervision from the audit committee substantially enhances the reliability of financial reports.

CONCLUSION

This study aimed to determine the extent of the contribution of independent variables to the dependent variable and the direction of the relationships, focusing on profitability, company size, and the audit committee's impact on earnings quality. Based on the analysis presented in the previous chapter, the conclusions are that profitability does not influence earnings quality, as companies with high profitability are suspected of engaging in earnings management practices.

Company size does not influence earnings quality, as smaller companies tend to receive less public attention and face greater challenges in growth opportunities. The audit committee has a significant positive effect on earnings quality because the audit committee's oversight ensures that financial reporting is thorough, resulting in high-quality and accountable earnings. When considered together, profitability, company size, and the audit committee affect earnings quality. High profitability indicates that the company has a strong potential to generate future profits and reflects superior earnings quality. Companies with large total assets are perceived as more stable and capable of producing superior earnings than those with smaller assets. Additionally, the presence of an audit committee that carries out detailed supervision positively impacts earnings quality.

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