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The Effect of Profitability, Leverage, and Firm Size on Earnings Quality with Independent Commissioners as Moderating Variable

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ABSTRACT

This study aims to analyze the effect of profitability, leverage, and firm size on earnings quality with an independent commissioner as a moderating variable. The population in this study are all manufacturing companies listed on the Indonesia Stock Exchange (IDX) during 2016-2018. The sample selection uses a purposive sampling technique that produces a sample of 41 companies. The method used in this study is the documentation technique using secondary data derived from financial statements. The analytical tool used is Moderate Regression Analysis (MRA) with the help of SPSS software version 22. The results of this study indicate that profitability and firm size significantly have a positive effect on earnings quality. Meanwhile, leverage significantly has a negative effect on earnings quality. The effect of profitability and leverage on earnings quality cannot be moderated by independent commissioners. However, independent commissioners can only moderate the effect of firm size on earnings quality. The conclusion of this research is that companies can increase profitability and firm size and reduce the level of leverage to be able to produce quality profits by optimizing the proportion of independent commissioners in large companies.

INTRODUCTION

Financial statement is the final result of the accounting process which is designed as a source of information for interested parties. One of the benefits of financial statement for its users is to find out about the condition of a company. Financial statement is used by management as the main tool to show the results of performance in corporate operational activities.

To measure performance in operational activities in a company can use earnings information since for external parties, earnings are used to estimate earnings power, predict future earnings, and evaluate management performance. Companies with high earnings quality indicate that the goals of the companies have been achieved. In addition, qualified earnings can be seen from the openness of the company in reporting its earnings. Earnings quality is used to determine the condition of the company, especially its financial health, so it can be said that the quality of earnings is a sign that the company has shown actual economic conditions.

The importance of earnings information can drive managers to take various ways of presenting financial reports to attract investors. However, more information about the company is known by management when compared to shareholders. Thus, it does not rule out the possibility for managers to manipulate financial statements. Financial statement manipulation is an intervention by management when preparing financial statements to obtain personal gain. Thus, the quality of company earnings will decrease by the practice of financial statement manipulation.

One of the manufacturing companies that practice financial statement manipulation in Indonesia is PT Akasha Wira Internasional (ADES). Where in 2013 ADES comprehensive earnings increased by 11.8% or Rp. 98.6 billion from 2012 which was only Rp. 83 billion. However, after being audited, it turned out that PT Akasha Wira International's comprehensive earnings has decreased by 33% or Rp.56.6 billion. This is due to low net sales and increased expenses. The auditor's notes show that operating expenses increased by Rp 42 billion in 2013, while total sales were Rp 502.5 billion or increased so low, that is 5% of total sales in 2012 of Rp 476 billion (Yusrilandari et al., 2016). If cases of financial statement manipulation continue and even develop, it can reflect companies failing to report the actual eco-

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nomic conditions.

Based on the previous studies that examine earnings quality, there is still a research gap with varied results from the independent variables examined. To improve earnings quality, it is necessary to know the factors that can affect earnings quality. Thus, in this study, three independent variables are taken, namely profitability, leverage, and firm size.

Previous studies have examined the effect of profitability on earnings quality and have shown inconsistent results. Profitability has a positive effect on earnings quality (Heikal et al., 2014; Kurniawan & Suryaningsih, 2019), as high profitability will make earnings quality even higher. Profitability has a negative effect on earnings quality (Laoli & Herawaty, 2019; Ma & Ma, 2017; Risdawaty & Subowo, 2015) since companies with high levels of profitability can be suspected of manipulating financial statements. Profitability has no effect on earnings quality (Abughniem et al., 2017; Umobong & Ogbonna, 2017), due to profitability is not able to attract market responses to earnings information on companies.

In addition, previous studies on the effect of leverage on earnings quality have shown inconsistent results. Leverage has a positive effect on earnings quality (Risdawaty & Subowo, 2015; Abughniem et al., 2017), as high levels of debt can be used by companies to finance operating activities at the company, thus enabling the company to generate large earnings. Leverage has a negative effect on earnings quality (Laoli & Herawaty, 2019; Alves, 2014) since a high level of leverage will make the company more likely to violate the credit agreement. Leverage has no effect on earnings quality (Putra & Subowo, 2016), due to leverage is not the main focus seen by investors as a basis for investing.

The effect of firm size on earnings quality in the previous studies has shown inconsistent results. Firm size has a positive effect on earnings quality (Putra & Subowo, 2016), as the business continuity to improve financial performance will be higher if the size of a company is getting bigger. Firm size has a negative effect on earnings quality (Laoli & Herawaty, 2019; Alves, 2014), since the smaller the firm size, the smaller the effort in improving financial performance. Firm size does not affect earnings quality (Risdawaty & Subowo, 2015), as large or small companies do not determine the number of earnings generated.

This study aims to analyze the effect of profitability, leverage, and firm size on earnings quality as moderated by independent commissioners. The originality in this study lies in the addition of independent commissioner as a moderating variable which serves to strengthen or even weaken the effect of profitability, leverage, and firm size on earnings quality. Management supervision will be more effective if the proportion of independent commissioner increases so that the earnings quality will increase. The existence of independent commissioners is expected to help the company to minimize the occurrence of financial statement manipulation caused by the differences in interests between management and shareholders.

The theory related to the cases of financial statement manipulation is agency theory which states that there are differences in interests between agents and principals which can lead to conflict (Jensen & Meckling, 1976). According to Eisenhardt (2018), agency theory consists of two streams, namely positivist agency theory which discusses the relationship between agents and principals, while principal-agent research discusses conflicts of interest from one party to another party, where there is one party who does not follow orders from the second party. The agent is given the authority to manage the company well, but if the company cannot get profits, the principal can propose to replace managers who cannot make the owner of the company prosperous. This happens due to the agent usually wants high compensation for their performance, while the principal tends to want his company to get a large profit from investment activities.

Meanwhile, signal theory states that company information is mostly owned by company executives so that they will be encouraged to convey this information to parties who need it, especially potential investors (Ross, 1977). With the existence of signal theory, management is expected to provide signals to users of the company's financial statements, especially to potential investors as a basis for making investment decisions. The signal given by the company to increase profits is information about the company's performance in the form of good news or bad news.

Based on agency theory, conflicts can occur with the separation of ownership and management of the company since the principal and the agent have different goals. Profitability indicates the ability of a company to earn profits. A high Return on Asset (ROA) value can indicate that the earnings quality produced by the company is high, the higher the ROA value, the more investors will join the company (Risdawaty & Subowo, 2015). Investors tend to choose high qualified earnings in a company to invest because according to investors the company will generate maximum profits. This is reinforced by the results of the previous studies (Heikal et al., 2014; Kurniawan & Suryaningsih, 2019; Naimah & Utama, 2006).

H_1: Profitability has a positive effect on earnings quality

Related to agency theory, management as an agent that is given the authority from the lender or principal fulfill the obligations as a borrower by managing loan funds properly. Management will tend to manipulate earnings if the company is in an unfavorable condition and is supported by agency theory. To increase the return results to shareholders can use leverage as a basis for knowing the assets and sources of funds used by the company. This is reinforced by the results of the previous studies (Laoli & Herawaty, 2019; Putra & Subowo, 2016; Alves, 2014).

H_2: Leverage has a negative effect on earnings quality

Related to signal theory, earnings in companies can be a good signal for interested parties, especially investors as a basis for decision making. A positive signal in the form of earnings information that is free from financial statement manipulation will increase the trust in management performance. The larger the total assets owned by the company, the larger the size of the company, so that a larger-sized company will produce high qualified earnings. This is reinforced by the results of the previous studies (Tong & Miao, 2011; Putra & Subowo, 2016; Risdawaty & Subowo, 2015).

H_3: Firm size has a positive effect on earnings quality.

Previous studies have examined the effect of profitability on earnings quality and have shown inconsistent results (Ma & Ma, 2017; Umobong & Ogbonna, 2017; Laoli & Herawaty, 2019). The findings in the previous studies indicate that there are other variables can moderate the effect of profitability on earnings quality. Another variable that appears is independent commissioners as the moderating variable.

Based on agency theory, management who has more information can manipulate financial statement with the existence of differences in interests between agents and principals. The existence of independent commissioners can prevent fraud committed by management since independent commissioners are responsible for overseeing the running of company activities in achieving its goals. Independent commissioners have an important role in company supervision because they improve control over management actions (Bell et al., 2013). Companies that have a large number of independent commissioners are considered to increase corporate profitability, if the level of profitability is high, it can generate qualified profits. Thus, it can be said that independent commissioners can moderate the effect of profitability on earnings quality.

H_4: Independent commissioners moderate the effect of profitability on earnings quality.

Independent commissioners are used in this study since independent commissioners have no relationship with leaders, investors, and other members of the board of commissioners. In addition, independent commissioner is showed in this study as a moderating variable since the previous studies show inconsistent results (Alves, 2014; Valipour & Moradbeygi, 2011; Putra & Subowo, 2016).

Based on agency theory, management can act opportunistically in reporting company earnings to maximize their personal interests. Therefore, tight supervision needs to be carried out by independent commissioners on the management's actions and it is expected to be more active in monitoring managers in managing corporate debt so that managers can reduce financing that comes from debt to reduce the level of leverage. This is due to companies that have a low level of leverage will produce high qualified earnings. Therefore, independent commissioners can moderate the effect of leverage on earnings quality.

H_5: Independent commissioner moderates the effect of leverage on earnings quality.

Independent commissioners are members of the commissioners who have no internal relationship in the companies and behave independently. A large number of independent commissioners can reduce the practice of manipulating financial statements. Based on agency theory, firm size can be used as one of the objects used as an answer to whether management has presented financial statements properly or conversely. If management commits fraud, company owners will ask an independent commissioner to supervise management. The larger the size of the company indicates that the level of supervision the company has must be higher. Therefore, it is necessary to have many independent commissioners in to produce high qualified earnings. Based on the inconsistent results of the previous research (Alves, 2014; Putra & Subowo, 2016; Laoli & Herawaty, 2019), then independent commissioner is used as a moderating variable to moderate the effect of firm size on earnings quality.

H_6: Independent commissioner moderates the effect of firm size on earnings quality.

RESEARCH METHODS

This research was quantitative research with secondary data in the form of financial statements contained on the Indonesia Stock Exchange (IDX) on page www.idx.co.id. The population in this study were all manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2016-2018, totaling 163 companies. Sampling used purposive sampling method. The criteria for sampling can be seen in table 1.

Earnings quality in this study acted as the dependent variable. Independent variables used in this study were profitability, leverage, and firm size. Independent commissioner was added as a moderating variable. The definitions of the research variables can be seen in table 2.

The data analysis method used in this research was a statistical analysis method that used Moderated Regression Analysis (MRA), but beforehand classical

Table 1. Sampling Criteria

No.	Criteria	Elimination	Total
	Research population		163
1.	Manufacturing companies that consistently published audited reports for the 2016-2018 period	(54)	109
2.	Manufacturing companies that generated earnings during 2016-2018	(35)	74
3.	Manufacturing companies that reported the proportion of independent commissioners during 2016-2018	(15)	59
4.	Manufacturing companies that presented financial statements in rupiah (IDR) and the required data are incomplete	(18)	41
Total analysis units (3 years)			123
Outlier Data			(29)
Total analysis units			94

Source: Secondary data processed, 2019

Table 2. Operational Definition of Research Variables

Variables	Definition	Indicators	Scale of Measurement
Earnings Quality	Earnings quality is the ability of a company to keep the amount that can be consumed remains the same in one period (Putra & Subowo, 2016).	QIR =CFO/NI QIR = Quality of Income Ratio CFO= Cash flow from operations NI= Net Income (Putra & Subowo, 2016)	Ratio
Profitability	Profitability is the ability of a company to gain profits in showing company performance (Kurniawan & Suryaningsih, 2019).	ROA = (EAT/TA) x 100% ROA = Return on assets ratio EAT = Earnings after tax TA = Total asset (Kurniawan & Suryaningsih, 2019)	Ratio
Leverage	Leverage is a tool to see how well a company can depend on creditors to finance corporate assets (Kurniawan & Suryaningsih, 2019).	DAR = (TU/TA) x 100% DAR = Debt to Asset Ratio TU= Total Debt TA= Total Asset (Kurniawan &Suryaningsih, 2019)	Ratio
Firm Size	Firm size is the scale of a company by looking at the size of the income, total assets, and total equity (Kurniawan & Suryaningsih, 2019).	Size = Ln Total Asset Size = Firm Size Ln Total Asset = Natural Logarithm of Total Assets (Kurniawan & Suryaningsih, 2019)	Ratio
Independent Commissioner	Independent commissioners are commissioners who have no internal interest in the company (Mathova *et al.*, 2017).	KI = (TKI/Tcom) x 100% KI = Independent Commissioner TKI = Total Independent Commissioners TCom = Total Commissioners (Mathova et al., 2017)	Ratio

Source: Secondary data processed, 2019

assumption tests will be carried out so that the test results meet the BLUE (Best Linear Unbiased Estimated) criteria with a significance level of data testing (α) 0.05. The tests include normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test using SPSS version 22 software.

RESULTS AND DISCUSSIONS

Descriptive statistical analysis is an analysis to provide data description seen from the minimum, maximum, average, and standard deviation values. The results of the descriptive analysis for earnings quality, profitability, leverage, firm size, and independent commissioners are presented in table 3.

The results of the classical assumption test show that the data are normally distributed, the significance value is 0.200> 0.05. The result of the multicollinearity test shows that the Tolerance value is not less than 0.10 and the VIF value is not more than 10, so it can be said that there is no multicollinearity between independent variables. The result of the autocorrelation test uses the Durbin-Waston (DW-test) and shows that the D-W statistical value of 1.858 is greater than (du) 1.731 and less than (4-du) 4-1.731, so there is no autocorrelation. The result of the heteroscedasticity test shows unclear patterns on the graph plot and the Glejser test show all variables have significance values > 0.05, so it can be said that in the regression model heteroscedasticity does not occur.

The Adjusted R^2 value of 0.190 (19%) of the QIR variation can be explained by the existing independent variables, and the remaining 81% (100% –19%) is explained by other variables not examined in this study. The summary of the hypothesis testing results can be seen in table 4.

The Effect of profitability on earnings quality

Profitability has a positive and significant effect on earnings quality. This happens since companies with high rates of return can use their funds to finance all funding needs. Thus, high profitability will reflect the high quality of company earnings. In line with agency theo-

Table 3. Descriptive Statistics of the Research Variables

	N	Min	Max	Mean	Std. Deviation
QIR	94	.02	2.84	1.12	.64
ROA	94	1.10	17.51	7.18	3.88
DAR	94	11.61	71.61	37.92	15.81
SIZE	94	25.84	31.87	28.89	1.42
KI	94	20.00	66.67	39.44	10.04
Valid N (listwise)	94				

Source: Secondary data processed, 2019

Table 4. Summary of Hypothesis Test Results

No	Hypothesis	Regression Coefficient	T_{count}	Sig	Decisions
1.	Profitability has a positive effect on earnings quality (H_1)	0.027	2.039	0.045	Accepted
2.	Leverage has a negative effect on earnings quality (H_2)	-0.010	-3.034	0.003	Accepted
3.	Firm size has a positive effect on earnings quality (H_3)	0.084	2.404	0.019	Accepted
4.	Independent commissioners moderate the effect of profitability on earnings quality (H_4)	-0.001	-0.651	0.517	Rejected
5.	Independent commissioners moderate the effect of leverage on earnings quality (H_5)	-1.341	-0.032	0.975	Rejected
6.	Independent commissioners moderate the effect of firm size on earnings quality (H_6)	-0.008	-2.020	0.047	Accepted

Source: Secondary data processed, 2019

ry, a high profitability value indicates that the company has a high earnings level, so the higher the profitability, the more investors who join the company. Based on the previous research, the result of this study is in line with the results of the previous studies (Heikal et al., 2014; Kurniawan & Suryaningsih, 2019; Naimah & Utama, 2006).

The Effect of leverage on earnings quality

Leverage has a significant negative effect on earnings quality. This happens due to the higher the level of leverage in the company, the lower the quality of the generated earnings. Companies with low earnings quality are possible to violate credit agreements, so to present financial statements so that earnings look high, companies can do various ways.

In line with agency theory, management is an agent that is authorized by lenders or principals to fulfill the obligations as a borrower by managing loan funds properly. The management will tend to manipulate earnings if the company is in an unfavorable condition and is supported by agency theory. The result of this study is in line with the results of the previous studies (Laoli & Herawaty, 2019; Putra & Subowo, 2016; Alves, 2014).

The effect of firm size on earnings quality

Firm size has a significant positive effect on earnings quality. This is due to if the size of a company is getting bigger, it will affect business continuity in improving the company's finances, thus avoiding financial statement manipulation practices. In line with signal theory, earnings in the company can be used as a positive signal for interested parties, especially investors, as a basis for decision making. The larger the size of a company can be indicated by the number of total company assets so that a large-sized company can produce high qualified earnings. According to investors, large companies have a good level of operational stability, so the investors believe that the company can obtain high earnings. Based on the previous studies, the result of this study is consistent with the results of previous studies (Tong & Miao, 2011; Putra & Subowo, 2016; Risdawaty & Subowo, 2015).

The effect of profitability on earnings quality moderated by independent commissioners

Independent commissioners are not able to moderate the effect of profitability on earnings quality so that independent commissioners cannot act as the moderating variable. Thus, it can be said that no matter how many the proportion of independent commissioners in a company is not able to affect the quality of earnings. The addition of a large number of independent commissioners to oversee management so as not to manipulate financial statements that occur due to agency conflicts from differences in interests between agents and principals does not have an impact on the increase of earnings quality in the company. This is due to independent commissioners are appointed only to comply with regulations but do not carry out their duties properly so they cannot defeat the power held by the majority shareholder (Boediono, 2005).

The effect of leverage on earnings quality moderated by the independent commissioner

Independent commissioners are unable to moderate the effect of leverage on earnings quality. This is since the addition of independent commissioners is only to fulfill formal requirements, while majority shareholders have an important role so that they cannot improve the performance of independent commissioners (Boediono, 2005). As much as the proportion of independent commissioners in the company whose function is to supervise management who has an opportunistic nature in reporting company earnings to maximize their personal interests that occur because agency conflicts do not affect the quality of company earnings.

The effect of firm size on earnings quality moderated by the independent commissioner

Independent commissioners are able to moderate the effect of firm size on earnings quality, but the presence of independent commissioners weakens the effect of firm size on earnings quality. According to Egbunike & Odum (2018), this happens as ineffective supervision from independent commissioners will cause agency problems. That is with the increasing number of independent commissioners, the company will experience difficulties in distributing tasks, communication processes, and effectiveness in decision making. Thus, the companies tend to choose optimize the proportion of independent commissioners in the company with the hope that the quality of the resulted earnings will increase. It can be said that large companies with a large proportion of independent commissioners will reduce earnings quality. Meanwhile, large companies with an optimal proportion of independent commissioners will improve earnings quality.

CONCLUSIONS

This study provides empirical evidence that profitability and firm size have a positive effect on earnings quality, while leverage has a negative effect on earnings quality. In addition, independent commissioners cannot moderate the effect of profitability and leverage on earnings quality, but independent commissioners can moderate the effect of firm size on earnings quality.

In improving the earnings quality, the companies have considered factors including profitability, leverage, and firm size. Increased profitability and firm size can produce high qualified earnings since companies that have a high rate of return can use their funds to finance all funding needs and the company's business continuity will be better at increasing profits. A decrease in leverage level can improve the earnings quality as the low use of debt will reduce the company's obligation to pay debt principal and interest in large amounts. Besides, to generate qualified earnings, companies can optimize the proportion of independent commissioners in large companies so that independent commissioners can supervise effectively.

This study only uses one measurement for each variable. Further research is suggested to add measurements to the variables used in order to represent the entirety of each variable. In addition, the sample used in this study is only in manufacturing companies, further research is expected to take samples from different sectors so that the samples used in future studies are more varied.

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