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How Qualified is The Company's Earning Quality: a Study of The 100 Most Liquid Indonesian Companies

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ABSTRACT

Investor behavior can be reflected in the market price. Market price movement have strong correlation with market perspective about company earnings. Market does not always positively react to high earnings information, but should be high quality of earnings. High quality earnings can reflect the company's actual financial condition, which useful for investment decision making for investors, and determine business strategies for companies. The aim of this study is to obtain empirical evidence regarding the effect of earnings persistence, liquidity, growth opportunity, profitability, and capital structure toward earnings quality. The objects in this study are companies included in the Kompas100 Index, index that ranks 100 companies with the highest liquidity, consecutively during 2018-2020. Secondary data used was obtaining from financial reports and analyzed using multiple linear regression equations. This research found that companies which can generate profit from their main operation, not from foreign exchange or other income supposed to be companies with high quality earnings. Moreover, business strategic that such as market expansion,

differentiation even though in the early stage judge can improve quality of earnings.

Keywords: Earning Persistence, Growth, Liquidity, Profitability, Quality Of Earnings.

INTRODUCTION

The capital market plays an essential role in country's economy because it carries out two functions, namely the economic function to bridge those who have excess funds and those who need funds, and also finance function to provide opportunities to obtain returns from the funds invested. The capital market can also facilitates public to invest their capital in financial instruments. For public companies, additional capital can be used to support the development of their business. For the government, capital market is also useful for creating job opportunities, as well as supporting development through public companies that earns additional capital (Otoritas Jasa Keuangan, 2019). Indonesia government also encourage public by educating people about capital market through programme named "Yuk Nabung Saham" campaign. Many online trading facilities also provide convenience for investors in stock investment transactions. This attracted people's interest to invest in the capital market. Therefore, the number of investors has also increased in 2018-2020 which can be seen in Figure 1 below:



Figure 1. Graph of Total Investor in Capital Market 2018-2020 Based on SID
Source : The Indonesia Central Securities Depository (KSEI), www.ksei.co.id

Based on figure 1, during 2019 until 2020, there was an increase of 53.41% and 56.21% number of investors. To help investors choose stocks to invest, there are several stock indexes that can narrow down their choices to stocks with good performance. One of them is Kompas100 Index which ⁴⁵ has high liquidity, and a large market capitalization, also good fundamentals and performance.

Liquid stock indicates that the share are in great demand so it can be actively traded. Thus, investing in liquid stocks has the potential to get capital gains. Therefore, investors pay more attention to stocks with high liquidity, one of which is the Kompas100 Index. Thus, investors will give a high response to information about companies on the Kompas100 index, which is reflected in the stock prices' movement when the information is announced. In addition to high liquidity, the Kompas100 Index also has a large market capitalization. In the IDX Stock Handbook (2021), the stock market capitalization on the Kompas100 Index is IDR 4,935.9 trillion, which is 72.98% of the total market capitalization (IDR 6,763.37 trillion). The following is a comparison of the market capitalization value of the Kompas100 Index with other indices on the exchange based on data from the IDX Stock Handbook (2021):

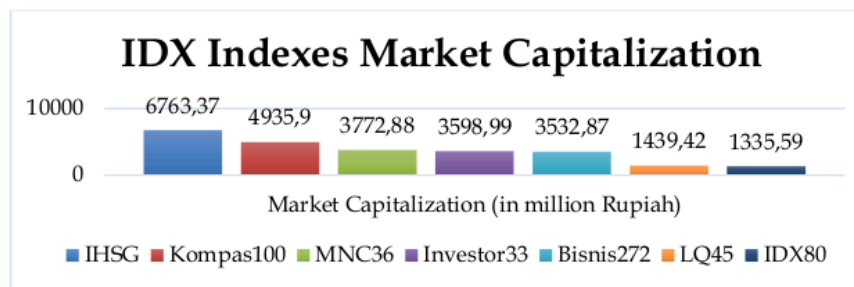


Figure 1. IDX Indexes Market Capitalization
Source: IDX Stock Handbook (2021)

According to Figure 2, the Kompas100 Index has a larger market capitalization than other indexes on the IDX. Market capitalization is the total value of shares traded on the capital market, calculated from ³⁷ the number of outstanding shares multiplied by ⁹ the share price. Therefore, the greater the number of outstanding shares and the company's stock price, the greater the market capitalization will be. Hence, companies with large market capitalization will have more investors than companies with small market capitalization, so that the information provided by the company will have an

impact on many capital owners. Consequently, companies in Kompas100 must maintain the quality of the information provided to stakeholders so that the information is in accordance with actual conditions and is not misleading.

For stakeholders, information is used to assess ² the company performance and predict the company's prospects in the future. One of the information that can be used to assess future performance and prospects is profit and loss information from the company's financial statements. When making an investment, investors will expect returns that match the performance and prospects of the company (Syakdiyah & Putra, 2021). Therefore, company profits can influence investors in making decisions regarding funding, in the form of buying and selling the company shares. Thus, investors will react according to the received and expected profit information, namely ⁹ the company's unexpected earnings. According to Paramita et al. (2020), "unexpected earnings is the difference between expected earnings and reported or actual earnings." Publication of profit information whose value exceeds market expectations will influence investors' policies to invest in the company's shares. This ⁴⁰ will increase the demand for the company's shares. If demand increases, the stock price will increase. Increased stock prices will provide a positive stock return. One example of investor reaction to company profits can be seen at Industri Jamu dan Farmasi Sido Muncul Plc. Based on profit and loss statement, ⁵⁴ the company managed to generate a net profit for the year of IDR 934.02 billion, which increased by 15.64% in 2020 from 2019, which was IDR 807.69 billion. "Along with the increase in performance, the share price with the SIDO code has increased. In the last three years, SIDO shares have strengthened by more than 200% (2018-2020), with a record high in 2020" (Situmorang, 2020). The increase in SIDO shares in 2020 can be seen in the following chart:



Figure 2. SIDO Share Price Movement in 2020

In Figure 1.3 it can be seen that during 2020, the price of SIDO shares has increased. SIDO shares increased by 25.78%, while the JCI (Jakarta Composite Index) decreased by -4.54%. This shows that there is a positive response to the increase in profits in the form of increased investor interest in stocks. This increases ² the demand for shares, so the share price increases. With the importance of profit information in making investment decisions, both companies and investors need to pay attention to the quality of earnings. Investors will respond positively to high quality earnings because it reflects the real condition of the company. High quality earnings information is also useful for the company's internal parties, for example for performance assesment, operating effectiveness and efficiency, funding needs, company's ability to pay, and others. Then, from the performance assesment, the company can make the right decisions, such as determining the company's strategy. High quality and high earnings information can also be used by companies to attract creditors and investors to provide funding to the company. For example, from the case of ¹² PT Industri dan Farmasi Sido Muncul Tbk, the positive reaction of investors to the company's 2020 profit indicates that the profit generated by the company has high earnings quality. High quality earnings will be useful for company decision making. According to Prima (2021), it is stated that from the increased profits in 2020, SIDO management set a net profit growth target of at least 10% for 2021. Then, the company also prepared a strategy based on 2020 performance. By looking at the significant increase in the performance of healthy drink products in in 2020, the company decided to focus on product diversification, especially for healthy drink products in 2021. This decision proved to have a positive impact on the company because the ¹² 2021 annual report stated that the diversification strategy by developing new products resulted in excellent sales growth and built strong fundamentals for the future. Sales of new products contributed 4% (Rp 160 billion) to total sales supported by strong sales performance, one of which was ¹² Sido Muncul C-1000 powder drink sweet orange variant which is a ⁴ new product from health drinks. In addition, sales of the food and beverage segment also increased by 18.3% from IDR 1.01 trillion to IDR 1.19 trillion in 2021. Apart from product diversification, profit information also has an impact on the

decision to pay dividends to investors. According to Ulfah (2021), along with a 16% increase in net profit in 2020, the company decided to distribute dividends of IDR 934.01 billion with a Dividend Payout Ratio (DPR) of 100%, increased from the 2019 DPR, which was 90%. From this case it can be concluded that the quality of earnings is important for companies to determine strategy, and it is also important for investors to make investment decisions because high quality earnings can provide credible information in accordance with the conditions of the company (Hao et al., 2019). Therefore, investors tend to be more interested in high quality earnings so they will react positively to high quality earnings. With this, the quality of earnings can be measured by the response of investors to company profits as seen from stock returns.

Actual stock return can be compared with the expected return by investors. The difference between actual and expected returns is referred to as abnormal returns. Abnormal return can describe a specific rate of return from the company alone without being influenced by market factors. Thus, unexpected earnings information can affect market reactions which can be measured from changes in the company's stock price which causes abnormal returns around the publication date of the company's financial statements.

The relationship between unexpected earnings and abnormal returns can be calculated using the earnings response coefficient (ERC). The movement of stock's abnormal returns will be accumulated into cumulative abnormal returns (CAR) and regressed by unexpected earnings (UE). The coefficient of the slope of the relationship between CAR and UE is referred to as the earnings response coefficient (ERC). ERC measures the size of stock market's abnormal return in response to the unexpected component of a firm's reported earnings (Ghozali, 2020). A high ERC indicates a high response from investors when receiving information about the company's unexpected earnings around the date of the publication of earnings which indicate quality of the earnings. Earnings quality is the quality of profit information available to the public which is able to show the extent to which profits can influence decision making and can be used by investors to assess companies (Septiana & Desta, 2021). With high

earnings quality, information from company earnings reflects the actual condition of the company, and will not mislead stakeholders in making decisions.

Earning quality can be influence by earnings persistence. Profit persistence is profit that has the ability to be an indicator of future profits generated by the company (Menicucci, 2020; Putra, 2022). Companies with persistent profits can maintain their profits in the long term, with permanent and not transitory profits. If the company has high profit persistence, ⁴ it means that the company is able to manage its assets to recreate increased profits in the next period so investor can make profit predictions. The profit prediction received by investors is reflected in ³⁸ the increase in the company's Earning Per Share (EPS). ³⁸ The increase in EPS causes the company's Unexpected Earnings (UE) to be high. In addition, with a high EPS, investors' expectations of receiving realized profits in the form of dividends will increase. Thus, the interest of investors to buy shares increases, and increases demand. This causes stock prices to rise, so that the actual return increases. The high actual return above the market return causes a high abnormal return. The high abnormal returns around the date of the UE announcement are accumulated to become a high cumulative abnormal return (CAR). Conditions in which the UE increases and is followed by a high CAR indicates that there is a positive reaction to the UE's announcement, which is marked by a high ERC. A high ERC indicates that there is a high response from investors to the company's earnings announcement. This indicates that profits can affect investors' decisions in investing, so that profits are considered to have high quality. Therefore, ⁴⁸ earnings persistence has a positive effect on earnings quality.

The second independent variable is liquidity. According to Weygandt (2019), "liquidity is the company's short-term ability to meet obligations and meet unexpected cash needs". This liquidity can be ²² proxied by the Current Ratio (CR). Current ratio ³³ measures a company's ability to pay off its short-term obligations using its current asset (Lessambo, 2018; Syakdiyah & Putra, 2021). ³⁵ If a company has a high current ratio, it means that the company has high current assets compared to its current liabilities, which means the company has positive net working capital, so it can be used to support operational activities. For example, funds available from current assets in the

form of cash can be used to purchase raw material supplies in large quantities as needed so as to get a volume discount. In addition, high cash funds can also be used to pay off accounts payable within the discount period, thereby obtaining a purchase discount. Discounts obtained by the company can reduce the value of raw material inventory. The reduced value of raw material inventory will reduce the cost of production, which is followed by a decrease ⁵² in the cost of goods sold when the inventory is sold. Purchasing raw materials in large quantities as needed can also boost company productivity. Increased productivity will drive increased sales. Increased sales accompanied by efficiency in cost of goods sold, companies can generate higher profits. Increased profits will increase the company's EPS so that the UE is high. In addition, with a high EPS, investors' expectations of receiving realized profits in the form of dividends will increase. Thus, the interest of investors to buy shares increases, and increases demand. This causes stock prices to rise, so that the actual return increases. The high actual return above the market return causes a high abnormal return. The high abnormal returns around the date of the UE announcement are accumulated to become a high cumulative abnormal return (CAR). Conditions in which the UE increases and is followed by a high CAR indicates that there is a positive reaction to the UE's announcement, which is marked by a high ERC. A high ERC indicates that there is a high response from investors to the company's earnings announcement. This indicates that profits can affect investors' decisions in investing, so that profits are considered to have high quality. Therefore, liquidity has a positive ⁵ effect on earnings quality.

The fourth independent variable in this study is ³¹ profitability. Profitability is an indicator of a company's ability to generate profits by using the resources owned by the company (Elviani et al., 2022; Putra et al., 2020). Profitability is proxied by Return on Assets (ROA) which can measure a ⁵⁰ company's ability to obtain net profit from managing its assets. If a company ¹⁴ has a high ROA, the company is able to manage its assets more effectively to generate high profits. For example, by optimizing the use of company asset capacity, such as machine production capacity. If the machine has not been used optimally, the company can receive special orders so that it can generate

higher sales which can then generate a higher contribution margin, without increasing the company's fixed costs, such as depreciation expenses. So that the allocation of fixed expenses for each product produced by the company becomes smaller. With higher sales and smaller allocation of fixed costs, the company can increase net profit. Increased profits will increase the company's EPS so that the UE is high. In addition, with a high EPS, investors' expectations of receiving realized profits in the form of dividends will increase. Thus, the interest of investors to buy shares increases, and increases demand. This causes stock prices to rise, so that the actual return increases. The high actual return above the market return causes a high abnormal return. The high abnormal returns around the date of the UE announcement are accumulated to become a high cumulative abnormal return (CAR). Conditions in which the UE increases and is followed by a high CAR indicates that there is a positive reaction to the UE's announcement, which is marked by a high ERC. A high ERC indicates that there is a high response from investors to the company's earnings announcement. This indicates that profits can affect investors' decisions in investing, so that profits are considered to have high quality. Therefore, it can be seen that profitability has a positive effect on earnings quality.

The last independent variable is capital structure. Capital structure is equity and debt funding in a company which is often calculated based on the relative size of various funding sources (Prabowo & Sutanto, 2019). Capital structure can be measured using the Debt-to-Equity Ratio (DER), which is a financial ratio that shows the relative proportion between equity and debt used to finance company assets (Silanno, Glousa Lera & Loupatty, 2021). Lower DER mean smaller use of debt, and greater use of equity to finance company assets. A low DER indicates that the company prefers to use equity rather than debt to finance its assets. With low debt, the available cash can be used for operational activities more than the cash needed to pay debt, it is expected to increase company productivity. For example, by conducting research and development (R&D) activities so that companies can produce products with new variants with more efficient production costs that can increase consumer interest. Increased consumer interest can increase sales. R&D activities can produce higher quality products, along

with cost efficiency. This can reduce quality costs associated with defects such as spoilage and rework. In addition, a low DER ²⁷ means that the company has a low debt composition, so that the interest expense will be low. Increased sales and efficiency of cost of goods sold and interest expense will increase net profit. Increased profits will increase the company's EPS so that the UE is high. In addition, with a high EPS, investors' expectations of receiving realized profits in the form of dividends will increase. Thus, the interest of investors to buy shares increases, and increases demand. This causes stock prices to rise, so that the actual return increases. The high actual return above the market return causes a high abnormal return. The high abnormal returns around the date of the UE announcement are accumulated to become a high cumulative abnormal return (CAR). Conditions in which the UE increases and is followed by a high CAR indicates that there is a positive reaction to the UE's announcement, which is marked by a high ERC. A high ERC indicates that there is a high response from investors to the company's earnings announcement. This indicates that profits can affect investors' decisions in investing, so that profits are considered to have high quality. Thus, the capital structure ¹⁹ has a negative effect on the quality of company earnings.

RESEARCH METHOD

The research object used in this research are companies that are included in the Kompas100 Index during 2018-2020. ⁴⁴ The data used is secondary data from annual financial reports published and daily share prices during 2018-2020. ²⁶ Financial reports were obtained through the official website of the Indonesia Stock Exchange (www.idx.co.id) and daily share price data were obtained from the investing.com site. Samples were taken by purposive sampling method with sampling criteria are listed in Kompas100 Index consecutively during 2018-2020, non-financial industry, no suspension and share split and also share reverse, earned consecutive profits, has a positive earnings persistence beta value. All the sample companies studied also required to have persistence of earnings in the, which is indicated by a simple regression significance value <0.05 . (Assuming whether there is profit persistence is

assessed as a whole from the samples taken). Multiple linear regression uses to analyze data. The following research sample criteria can be seen in table 1 below.

Table 1. Sample Criteria

No	Sample Criteria	Total Company
1	Companies listed in the Kompas100 Index consecutively during 2018-2020.	66
2	Companies in the non-financial industry.	57
3	Did not experience stock suspension during 2018-2020.	55
4	Did not launch share split and share reverse split in 2018-2020.	51
5	Companies with financial reporting periods starting from January 1 st and end on December 31 st in 2018-2020.	51
6	Successively published audited financial reports during 2018-2020.	51
7	Using the Rupiah currency during 2018-2020.	42
8	Earned consecutive profits during 2018-2020.	32
9	The company has a positive earnings persistence beta value.	18
10	There is a persistence of earnings in the sample companies studied, which is indicated by a simple regression significance value <0.05 .	18
Total company used for sample		18

RESULTS & DISCUSSION

Research Results

The Kolmogorov-Smirnov test result significance value of 0.033. Hence, it can be stated that the data is not normally distributed because the significance value is less than 0.05. For this reason, data transformation is carried out. The result of normality test after data transformation shows a Monte Carlo significance value of 0.114. The significance value is greater than 0.05, hence all research variables are normally distributed.

ERC has an average value (mean) of 0.043239 indicating that in the average if 100% of unexpected earning increase, 4.32% cumulative abnormal return will increase relatively. EP has average value of 1.131182 which means that average company sampled for this study will have increasing earnings before tax around 113.11% in the next year. CR has average value of 2.756191 means that in average, current asset of

company sampled in this study can cover 275% of their current liability. MBV has an average value of 3.075948 that means in average, public appraise 3.07 times higher than its book value. ROA has average value of 0.095395 which means that companies used as sample can generate 9.53% profit from each dollars of their asset. DER has average value of 0.942815 which is smaller than 1, means that company financing cources come from equity. The following are the results of descriptive statistical tests can be seen in table 2 below:

Table 2. Results of Descriptive Statistics

	N	Range	Minimum	Maximum	Mean
ERC	54	5,5594	-2,5426	3,0168	,043239
EP	54	7,0471	,1265	7,1736	1,131182
CR	54	7,0786	,6730	7,7516	2,756191
MBV	54	12,9366	,2017	13,1384	3,075948
ROA	54	,3007	,0010	,3017	,095395
DER	54	2,9451	,1437	3,0888	,942815
Valid N	54				

Multicollinearity test resulted the variance inflation factor (VIF) value for all independent variables is less than 10 and the tolerance value is greater than 0.10. Thus, there is no multicollinearity in the independent variables. Results of autocorrelation test using the Durbin-Watson test yield a value of 1.853. This value is between dU value (1.7684) and 4-dU (2.2316), so it was concluded that there was neither positive nor negative autocorrelation in the regression model. The results of the Heteroscedasticity test based on the scatterplot graph in Figure 4.3 show that the dots spread randomly, there is no clear pattern, and they spread both above and below 0 on the Y axis and do not form a specific pattern (wavy, widened, then narrowed). Therefore, there is no heteroscedasticity in the regression model studied.

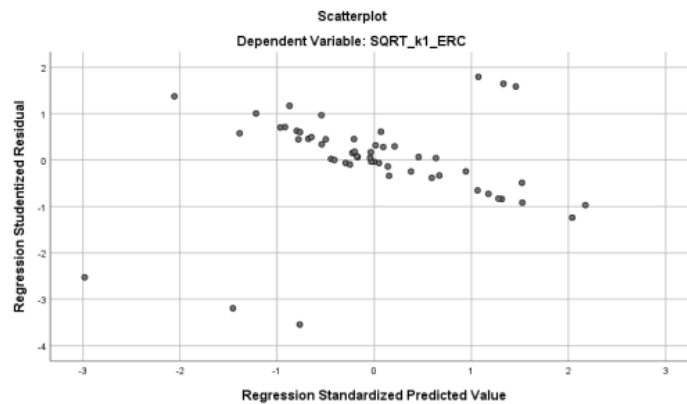


Figure 4. Result of Heteroscedasticity Test

Hypothesis Testing

Correlation coefficient value based on R value is 0.509 or 50.9%, indicates that the relationship between the independent variables, namely earnings persistence, liquidity, growth opportunity, profitability, and capital structure with the dependent variable, the quality of earnings is moderate because it is in the range of 0.40-0.599. The value of Adjusted R² is 0.182, indicates that the variable earnings persistence, liquidity, growth opportunity, profitability, and capital structure explain the quality of earnings variable by 18.2%, while the remaining 81.8% is explained by other variables not examined in this research.

The F test value is 3.362 with a significance value of 0.011. This value is less than 0.05, so it can be concluded that the variables of earnings persistence, liquidity, growth opportunity, profitability, and capital structure together have a significant effect on the quality of earnings. Therefore, the results of this study are in accordance with the results of research by (Aminatu Rizqi et al., 2020), (Elviani et al., 2022), and (Kurniawan & Suryaningsih, 2019) which states that the variables of earning persistence, growth opportunity, and income smoothing simultaneously have a significant effect on the quality of earnings. In this study, the degree of freedom (df) was 5, the residual df was 48, and $\alpha = 0.05$, so that the F table value was 2.41. The calculated F value of 3.362 is greater than the table F value ($3.362 > 2.41$). Therefore, it can be stated that the sample regression function in estimating the actual value is correct. The result of t-test shown in table 3 below:

Tabel 3. Result of Statistical t Test

	B	Sig.
EP	0.046	0.028
CR	0.077	0.028
MBV	-0.094	0.004
ROA	3.563	0.009
DER	0.062	0.385
Constant	1.554	0.000

The EP variable has a t-test result of 2.269 with a significance level of 0.028. This shows that the significance value is less than 0.05 and indicates a positive t value. It can be concluded that the EP variable has a significant positive effect on the quality of earnings so that Ha₁ is accepted. The results of this study are in accordance with the results of research by Rizky, Murdayanti, and Utamingtyas (2020), which states that earnings persistence has a significant positive effect on the quality of earnings.

The CR variable has a t test result of 2.441 with a significance level of 0.018. This shows that the significance value is less than 0.05 and indicates a positive t value. It can be concluded that the CR variable has a significant positive effect on the quality of earnings so that Ha₂ is accepted. The results of this study are in accordance with the results of Assagaf's research (2022) which states that liquidity has a significant positive effect on the quality of earnings.

The MBV variable has a t-test result of -2.996 with a significance level of 0.004. This shows that the significance value is less than 0.05 and indicates a positive t value. It can be concluded that the MBV variable has a significant negative effect on the quality of earnings so that Ha₃ is rejected. The results of this study are in accordance with the results of research by (Aminatu Rizqi et al., 2020) which states that growth opportunities have a significant negative effect on the quality of earnings. Of the 54 observations, there are 30 observations with MBV values below the average. Then from the 30 observations, there were 24 observations with ERC values above the average. Thus, it can be seen that MBV has a negative effect on ERC. Even though it has a low MBV, the 24 observations are still expanding, so they can grow. This can be seen from the increase in the company's fixed assets on average by 8.114%, which was dominated by an increase in land by 36.786%. The land is then used by the company to build a

new factory so as to increase production capacity. Thus, the company can still increase its net profit by 1.797%. The increase in the company's profit received a positive response from investors, so that the average ERC was positive by 0.1816.

The ROA variable has a t-test result of 2.706 with a significance level of 0.009. This shows that the significance value is less than 0.05 and indicates a positive t value. It can be concluded that the ROA variable has a significant positive effect on the quality of earnings so that H_{a4} is accepted. The results of this study are in accordance with the results of research by (Elviani et al., 2022; Putra, 2022) which state that profitability has a significant positive effect on the quality of earnings.

The DER variable has a t-test result for the DER variable of 0.877 with a significance level of 0.385. This shows that the significance value is greater than 0.05 and indicates a positive t value. It can be concluded that the DER variable has no significant effect on the quality of earnings so that H_{a5} is rejected. The results of this study are in accordance with the results of research by Elviani et al (2022) which state that capital structure has no effect on the quality of earnings. Of the 54 observations, there were 34 observations with below average DER values. Then from the 34 observations, there were 19 observations with ERC values below the average. In 19 observations, even though they had a low DER, the DER increased from the previous year by 7.833% on average. This increase happened because liabilities increased more than equity, which was 17.27%, while equity only increased 9.598% from the previous year. This also made the financial expense increase by 66.521% from the previous year. So, even though the company has a small DER, the company's debt has increased so that the financial expense rises. In addition, although the company succeeded in increasing its gross profit by 8.538%, the company's net profit increased in proportion to its gross profit by 8.896%. So there is no efficiency in expense on these companies. This makes investors not interested in increasing company profits, thus showing a low response. A low response causes a low ERC value, which is an average of -0.5714. Thus, DER has no effect on the quality of earnings.

CONCLUSION

Based on the results of research and discussion, it can be concluded that persintesi, liquidity and profitability have a positive effect on earnings quality, while growth opportunity and capital structure have a negative effect on earnings quality. The implication of this research is that this study shows that overall, the market responds positively to companies that experience an increase in profits derived from the company's main activities, and cost efficiency. So that the increase in profits from the company's main activities and cost efficiency carried out by the company can affect earnings quality.

The limitation in this study is that the independent variables in this study cannot fully explain the dependent variable. This can be seen from the Adjusted R Square value of 0.182 or 18.2% and the remaining 81.8% is explained by other variables not examined in this study. This study uses the Kompas100 Index sample so that the companies used as samples come from various sectors. Analysis can be done more accurately if done in the same type of sector. Thus, for further research it is recommended to use similar sectors or conduct analysis per type of sector.

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