# Accrual Earnings Management and Earnings Quality: Studies on Manufacturing Companies Listed of The Indonesia Stock Exchange

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**ABSTRACT**

This study aims to determine the effect of accrual earnings management on earnings quality in manufacturing companies listed on the Indonesia Stock Exchange in 2010-2019. The research samples are 49 companies (490 firm years). This study uses multiple regression test to examine variables that are thought to affect earnings quality. This study uses earnings quality as the dependent variable, while accrual earnings management and firm size are independent variables. The results showed that accrual earnings management has a negative effect on earnings quality, while size has a positive effect on earnings quality. Liquidity, which is the control variable, has a positive effect on earnings quality.

Keywords: accrual earnings management; earnings quality; size; liquidity.

## 1. INTRODUCTION

Financial reports are one way for managers to communicate with stakeholders. Managers have the responsibility to run the company's operations properly. Meanwhile, stakeholders can assess the performance of managers by looking at the condition of the company through financial reports. Financial reports must present complete information and be easily understood by all parties. Earnings quality is an important aspect in assessing a healthy company's financial condition, but it is often ignored by investors and creditors. Investors consider earnings to be a component that must be considered in financial reports because the quality of earnings can be influenced by management behavior (Palupi, 2023). Earnings quality will affect the decisions taken by stakeholders.

Earnings quality is earnings that can reflect the real condition of the company and there is no manipulation from company management, one of which is earnings management (Sanjaya and Devie, 2017). Management manipulates financial reports with the aim that financial reports look better, earnings look higher or lower according to the goals that management wants to achieve (Kurniawansyah, 2018).

Earnings management can be divided into accrual earnings management and real earnings management. The practice of accrual earnings management has been replaced by real earnings management since the issuance of the Sarbanes-Oxley Act because real earnings management is considered more difficult to detect by auditors and regulators (Chan *et al.*, 2015). However, previous research has proven that accrual earnings management practices in Indonesia are still quite high (Purwaningsih and Kusuma, 2020). This is presumably because Indonesia adheres to the civil law legal system (Purwaningsih


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and Kusuma, 2020) and the law enforcement system in Indonesia is quite weak (Leuz, Nanda and Wysocki, 2003). In addition, other research shows that compared with real earnings management, accrual earnings management has a stronger association with earnings quality (Purwaningsih, Kusuma and Barokah, 2020). Therefore, this study will use accrual earnings management.

Accrual earnings management is done by playing accrual components in financial reports. Earnings management carried out by company managers can reduce the reliability of the presented earnings because the earnings information presented in the financial statements is biased and it does not reflect the actual financial condition of the company (Sanjaya and Devie, 2017). The low quality of earnings information occurs because the presenters of financial statements try to mislead users of financial statements (Siallagan, 2009). Therefore, this study wants to obtain empirical evidence regarding the effect of accrual earnings management practices on earnings quality.

## 2. RESEARCH PROBLEMS

There are two research problems, namely: (1) Does accrual earnings management have a negative effect on earnings quality? (2) Does firm size have a positive effect on earnings quality?

## 3. THEORY AND HYPOTHESIS DEVELOPMENT

### 3.1. Agency Theory

Agency theory is a contract that underlies the relationship between principal and agent. The principal assigns the agent to carry out work in the interests of the principal by delegating decision-making authority to the agent (Jensen and Meckling, 1976). Managers who directly manage companies certainly have more information about company conditions and company prospects than owners, so managers have the responsibility to report company information to owners (Luayyi, 2012). The difference in the amount of information causes information asymmetry (Puspaningsih and Ristya, 2022). The existence of information asymmetry between managers and users of financial reports can provide opportunities for managers to report company financial information in accordance with their desire to gain earnings (Kurniawansyah, 2018). This can happen when both parties try to maximize the utility they get so that the agent does not always act according to the wishes of the principal (Jensen and Meckling, 1976). The difference in interests between agents and principals causes managers to report earnings opportunistically to fulfill their personal interests (Nanang and Tanusdjaja, 2019). Therefore, management performs earnings management.

### 3.2. Accrual Earnings Management

Earnings management is defined as the actions of managers in tricking stakeholders who want to know the company performance by playing with the information contained in the financial statements. In contrast to fraud, earnings management includes the selection of accounting methods and estimates in accordance with GAAP. This shows that companies which practice earnings management will manage their earnings in accordance with the limitations that are still acceptable in accounting procedures (Ghazali, Shafie and Sanusi, 2015). Accrual earnings management can be carried out because managers have the freedom to determine the accounting method used in practice (Sa’diyah and Hermanto,


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2017). Accrual earnings management is done by manipulating accrual elements in financial reports because it is easy for those who record and prepare financial reports to play with accrual elements.

### 3.3. Earnings Quality

Earnings quality is how capable earnings reflect actual earnings and predict future earnings from the stability and persistence of earnings (Lee and Azis, 2023). High quality earnings in financial reports can reflect the actual condition of the company and are far from practicing earnings management. Earnings quality can be used as a basis for making good decisions (Nanang and Tanusdjaja, 2019). One indicator of earnings quality is earnings persistence (Dechow, Ge and Schrand, 2010). Persistent earnings is earnings that can reflect sustainable earnings in the future which is determined by the accrual component and its cash flow (Farichah, 2017).

### 3.4. Hypothesis Development

#### 3.4.1. Accrual Earnings Management and Earnings Quality

Earnings quality is earnings that can be used as a basis for decision making and can be used to predict future stock returns and prices (Sanjaya and Devie, 2017). Earnings quality can be a sign of quality financial information (Helina and Permanasari, 2017). Earnings is an important component of financial statements, but often do not reflect the actual condition of the company due to earnings management practices (Ananda and Ningsih, 2016). High earnings management practices can provide an indication of low earnings quality (Siallagan, 2009). High earnings quality occurs when earnings management practices are not found in a company and the lowest earnings quality is found when companies practice earnings management (Sulaeman, 2019). Therefore, the higher the practice of earnings management, the lower the quality of company earnings (Lo, 2008).
Hypothesis 1: Accrual earnings management has a negative effect on earnings quality.

#### 3.4.2. Firm Size and Earnings Quality

The political cost hypothesis states that the larger the size of the company, the more people will pay attention to firm (Scott, 2012). Consequently, more and more stakeholders want to access company data. With large company resources, the company is increasingly able to manage a good information system. This will lead to more and more information about the company in the public. Therefore, companies will be more careful in their actions, especially in matters related to accrual earnings management practices. Moreover, accrual earnings management is easier for auditors and regulators to detect (Chan *et al.*, 2015)**.** The larger the company size, the lower the accrual earnings management. Therefore, when earnings management practices are low, the higher the earnings quality is.
Hypothesis 2: Firm size has a positive effect on earnings quality.

## 4. RESEARCH METHODS

The research sample is a manufacturing company listed on the IDX in 2010-2019. Selection of the sample uses purposive sampling. The number of observations is 490 firm years.

This study uses accrual earnings management and firm size as independent variables. Accrual earnings management is proxied by Modified Jones (Dechow et al.,


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1995), while firm size is proxied by natural log total assets. Meanwhile, the dependent variable is earnings quality. Earnings quality variable is proxied by earnings persistence (Dechow et al., 2010). The control variable in this study is the company's liquidity proxied by the current ratio.

This study conducted data normality tests and classical assumption tests (multicollinearity, heteroscedasticity, and autocorrelation tests) before testing the hypothesis. Hypothesis testing is done by multiple linear regression test.

## 5. RESULTS AND DISCUSSION

This study uses a sample of companies in the manufacturing industry listed on the Indonesia Stock Exchange in 2010-2019. The number of observations is 490 firm years. Descriptive statistics for the research data are presented in Table 1, including the minimum, maximum, mean, and standard deviation values.

Table 1. Descriptive Statistics

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| AEM | 490 | -.22 | .68 | .0305 | .08071 |
| Size | 490 | .15 | 11.74 | 2.2288 | 1.52046 |
| Liquidity | 490 | 12.21 | 19.68 | 15.0753 | 1.54264 |
| Earning Quality | 490 | -14.90 | 14.74 | .9199 | 2.15579 |
| Valid N (listwise) | 490 | | | | |

The results of the Kolmogorov-Smirnov Test show that the data are normally distributed (asymp.sig=0.245). The results of testing the classical assumptions also show that this study is free from multicollinearity, heteroscedasticity tests, and there is no autocorrelation between research variables.

The test results show that the goodness of fits has a p-value of 0.000. Thus, the research model is feasible to be used to test the effect of accrual earnings management. company size, and liquidity on earnings quality.

Table 2. Hypothesis Testing

| Model | Unstandardized Coefficients | | t | Sig. |
|---|---|---|---|---|
| | B | Standard Error | | |
| Constant | -1.708 | .802 | -2.130 | .034 |
| AEM | -1.039 | .377 | -2.757 | .006 |
| Size | .826 | .296 | 2.794 | .005 |
| Liquidity | .107 | .048 | 2.245 | .025 |

Dependent Variable: EQ

Based on the results of testing the hypothesis in Table 2, the research model is as follows:

$$EQ_{it} = -1.708 - 1.039\ AEM_{it} + 0.826\ Size_{it} + 0.107\ Liquidity_{it} + + e$$


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Information:
EQ= earnings quality of company i, year t
AEM=accrual earnings management company i, year t
Size=firm size company i, year t
Liquidity=liquidity company i, year t
e=errors

The results showed that the accrual earnings management coefficient was -1.039, with a p-value of 0.006. Thus, accrual earnings management has a negative effect on earnings quality. The more intense management performs accrual earnings management, the lower the earnings quality. This is because the higher the management intervention in the company's financial reporting, the less it reflects the actual condition of the company. This can mislead financial statement users who base their decision making on financial report figures, including company earnings. Therefore, it can be said that the more intense the practice of earnings management, the lower the earnings quality.

The existence of earnings management causes the earnings presented to be not in accordance with the actual earnings made by the company. This discrepancy in reported earnings makes the information contained in the financial statements biased and erroneous, resulting in low quality earnings. This causes investors to make wrong decisions because the information regarding presented earnings cannot reflect the actual financial condition of the company. Conversely, when earnings management practices are not carried out in the preparation of company financial statements, the financial statements contain unbiased information. Thus, this information can be used by investors as a basis for making decisions because it is in accordance with the actual condition of the company. Therefore, financial reports which do not indicate earnings management can be said to have quality earnings.

The results of this study are in line with Purwaningsih's research, which states that accrual earnings management is significantly associated with earnings quality (Purwaningsih, Kusuma and Barokah, 2020). Furthermore, this study compares the strength of the association between accrual earnings management and real earnings management on earnings quality. The results show that compared with real earnings management, accrual earnings management has a stronger association with earnings quality.

The variable coefficient of firm size is 0.826, with a p-value of 0.005. The test results indicate that firm size has a positive effect on earnings quality. The larger the size of the company, the higher the quality of earnings. This can be explained by the fact that the larger the size of the company, the more it gets public attention. In addition, information on large companies is also more accessible or available to the public than small companies. Therefore, the larger the size of the company, the more careful the company is in managing accrual earnings. Because accrual earnings management practices are more easily detected by auditors and regulators (Chan *et al.*, 2015).

The coefficient of the liquidity control variable is 0.107, with a p-value of 0.025. Thus, liquidity has a positive effect on earnings quality. Thus, the higher the company's liquidity, the higher the quality of earnings.

Adjusted R-Square value of 0.035. This shows that the variable accrual earnings management, liquidity, and firm size can explain the quality of earnings by 3.5%.

## 6. CONCLUSION, IMPLICATION, AND FUTURE RESEARCH


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### 6.1 Conclusion

This study aims to obtain empirical evidence regarding the effect of accrual earnings management practices on earnings quality. The results of the study show that accrual earnings management has a negative effect on earnings quality. Thus, the higher the level of accrual earnings management, the lower the level of earnings quality. The practice of high accrual earnings management means that management intervention in reporting earnings is getting higher. Consequently, the earnings presented in the financial statements are not in accordance with the actual condition of the company. If a decision is taken based on financial reports that are not in accordance with the actual conditions, the decision taken will be less precise. In other words, the numbers in the financial statement accounts become less reliable/low quality, including the quality of the company's earnings account.

### 6.2 Research Implication

This research has theoretical, empirical, and practical implications. The first theoretical implication, the results of this study support and implement agency theory. Second, this research also empirically proves the developmental research on accrual earnings management and earnings quality, namely accrual earnings management is not weakened by real earnings (Chan *et al.*, 2015), but still occurs in Indonesia. The results of this study complement Purwaningsih and Kusuma (2020) research, which states that accrual earnings management practices still occur in Indonesia, even though earnings management practices are lower than real earnings management practices. Thus, the practice of accrual earnings management is not substituted by real earnings management, but the two complement each other.

This research is also an extension of previous research which states that accrual earnings management is significantly associated with earnings quality (Purwaningsih, Kusuma and Barokah, 2020). Furthermore, compared with real earnings management, accrual earnings management has a stronger association with earnings quality.

Third, this research has practical implications and can become an initial reference in the formulation of regulations regarding disclosure and flexibility in accounting rules. Why is that? Because of the breadth of disclosure and the flexibility of accounting rules, management uses it to manage earnings. The Financial Accounting Standards Board (DSAK) and the Financial Services Authority (OJK) can use the results of this research as one of the considerations in making regulations as an effort to prevent earnings management practices that utilize financial reports as well as to strengthen and improve earnings quality.

This research also has implications for investors. Investors should not be naive. In fact, management practices earnings management so that investors must be careful and wise in using accounting data in making investment decisions.

### 6.3 Future Research

Future researchers can conduct research with research samples from various industries so that comparisons between industries can be carried out. Thus, a more in-depth analysis of the research can be carried out and the generalization of the research results can be better.

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