# CORPORATE GOVERNANCE MECHANISMS AND EARNINGS QUALITY: IS FIRM SIZE A MODERATION VARIABLE?

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## Abstract

The main objective of this research is to analyze the influence of independent commissioner, audit committee, managerial ownership, and institutional ownership on earnings quality. This study also observes the role of a firm's size as a moderating variable. Using specific considerations, the number of the sample is reduced to 20 out of 144 companies from manufacturing companies listed in the Indonesian Stock Exchange during 2013–2016. The data analysis in this research used moderating regression. The results show that managerial ownership affects positively toward quality of the earnings. The firm's size has proven to be able to strengthen the influence of managerial ownership and institutional ownership on earnings quality. Overall, this study reveals that the implementation of good corporate governance has been obliged by the government, but the supervisory function has not been executed optimally so it is not fully able to affect earnings quality. The results of this study contribute to both investors and potential investors in investment decisions. This paper suggests considering managerial and institutional ownership and company size since the variable is proven to be able to improve earnings quality.

**Keywords:** Earning Quality, Cash Flow, Firm Size, Audit Committee, Independent Commissioner, Institutional Ownership, Managerial Ownership, Corporate Governance

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## 1. INTRODUCTION

The financial statement provides information for various interested parties. Earnings are also used as a tool to measure corporate management performance during a certain period. On the other hand, earnings are often used as an indicator to estimate corporate prospects in the future (Khafid, 2012). According to Schipper and Vincent (2003), earnings quality in particular and the quality of financial statements, in general, are important for stakeholders. Shareholders usually use earning information from the financial statement to make their business decisions. Kalantonis, Schoina, and Kallandranis (2021) argue that earning quality (earning management) impacts the credibility of financial statement, which could steer to significant financial criminals and a possible capital market crisis. For investors, information about earnings reported by the company is very important to find out the earnings quality of a company, this aims to reduce the risk of information. Menicucci (2020) in her recently published book mentions that financial reports have become the key foundation of information for stakeholders, and above all, profit is the most important accounting numbers that managers, directors, investors, and other stakeholders rely on for their business decisions. Investors expect earnings quality information reported by the company is high because it is a signal of high resource allocation in a company.

There is some evidence of earnings manipulation scandals from large corporations around the world that have raised doubts for investors and also disrupted confidence in corporate financial statements, such as the Enron, WorldCom, and Xerox case (Miko & Kamardin, 2015; Sorensen & Miller, 2017). The manipulation has taken a loss for investors. The same case has also taken place in the manipulation of financial statements of companies listed on the Indonesia Stock Exchange (for example, INVS and SIAP in 2015, GIAA in 2018). It is important to achieve earnings quality, although earnings quality is not the only means of ensuring that the company does not fail, but it is one of the important factors that must be considered to avoid financial distress (Obaid & Yasir, 2020). Baskaran, Nedunselian, Ng, Mahadi, and Abdul Rasid (2020) discuss the extent to which earnings management is considered a business strategy or deliberate manipulation in an organization. Scandals and large-scale corporate collapses have prompted a strong need to ensure reliable and transparent financial reporting.

Leuz and Wisocky (2016) argue that manager incentives are based on targets, and they often custom profits to manipulate results to achieve these targets. Profit is also often the basis in determining the number of bonuses for managers, this has caused managers to prepare financial statements that benefit them. Managers are often involved in earnings management to raise profits to achieve targets (Sae-Lim & Jermsittiparsert, 2019).

Various studies have been conducted, related to the variables that are considered to affect earnings quality. One of them that has a close relationship with the earnings quality variable is the governance mechanism which is widely known as corporate governance (CG). Okoi, Ocheni, and Sani (2014) argue that most of the opportunistic policies that result in earnings management are associated with poor corporate governance, which has become one of the most debated issues worldwide. Corporate governance is related to the relationship between managers, directors, controllers, minorities, and other stakeholders (Wahyudin & Solikhah, 2017). Good corporate governance is defined as concepts proposed for the sake of improving company performance through supervision or monitoring of management performance and ensuring management accountability to stakeholders by basing it on the existing regulatory framework (Rahmawati, 2013).

Since the importance of earnings information in the company's financial statements, profits reporting should meet relevant and reliable information. Therefore, it is very important to explore the determinants that can improve earnings quality. This is the first study to examine the role of a company's size in strengthening the influence of corporate governance mechanisms on earnings quality. Previous studies provide a direct effect of firm's size and corporate governance variables on earnings quality without considering the firm's size as a moderating variable. The purpose of this study is to analyze and describe the effects of independent commissioners, audit committee, managerial ownership, and institutional ownership on earnings quality and firm's size in moderating the effects of the independent commissioner, audit committee, managerial ownership, and institutional ownership on earnings quality. The originality in this study is the firm's size variable as a moderating variable. The larger firm's size has the possibility of a higher agency problem so that the implementation of CG will be more needed. The increased implementation of CG encourages companies to be more obedient and transparent in managing financial reporting so that the earnings reported by companies are getting better.

This paper highlights some research questions (RQs) as follows:

*RQ1: Do audit committee, independent commissioner, institutional ownership, and managerial ownership affect the earning quality?*

*RQ2: Does the company's size moderate the relationship between the corporate governance mechanisms and the earning quality?*

This paper investigates 56 observation units of manufacturing companies listed on the Indonesia Stock Exchange with the criteria that some of their shares are owned by management and institutions. Two main regression models are developed in the current study. A multiple regression model is developed to answer the first research question (*RQ1*) and an interaction multiple regression model — to solve the second question (*RQ2*).

The remainder of the paper is organized as follows. Section 2 reviews the relevant literature and develops hypotheses. Section 3 covers the methodology used in this study describing the empirical model and the sample. Section 4 presents the main results. Section 5 discusses the empirical analyses and Section 6 reports the main conclusions of the study, its limitations, and potential avenues for future research.

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### 2.1. Literature review

Obaid and Yasir (2020) explained that in recent years, accountants and users of financial statements have paid attention to earnings quality. Quality earnings are important information, but so far, there is no definitive definition of earnings quality. More precisely, there are many definitions, but there are no universally accepted definitions. In the most general terms and accepted by most researchers related to the concept of earnings quality, this relates to the cash flow from operations (Obaid & Yasir, 2020). If current profits are higher than operating cash flow, this means that the company is of low quality and has a low ability to generate profits (Lyimo, 2014).

To reduce financial scandals and to increase earning quality, there has been increasing attention towards developing and implementing corporate governance mechanisms (Sorensen & Miller, 2017). Corporate governance is a system that directs and controls a company. Wahyudin and Solikhah (2017) state that corporate governance is related to the relationship between managers, directors, controllers, minorities, and other stakeholders. Furthermore, good corporate governance is defined concepts proposed for the sake of improving company performance through supervision or monitoring of management performance and ensuring management accountability to stakeholders by basing it on the existing regulatory framework (Rahmawati, 2013; Susilo, 2018). Companies try to build harmony between the social values associated with them and norms of behavior that are acceptable in the larger system to which they are part of it. Therefore, the higher conformity of social norms between society and the company can make the company more legitimate.

Good corporate governance is one of the means by the company in maintaining its legitimacy to the community. The implementation of corporate governance will encourage companies to pay attention to their role in the community. Asghar, Sajjad, Shahzad, and Matemilola (2020) reveal that corporate governance can suppress earnings management practices and eliminate the risk of developing opportunistic behavior among managers so that actions that lead to fraud can be reduced. Corporate governance has two monitoring mechanisms: internal supervision and external supervision (Lestari, Wahyudi, Muharam, & Nur Utomo, 2020). Internal mechanisms can be carried out by the board of commissioners, internal control, and the internal audit function. Meanwhile, external supervision can come from investors or shareholders, creditors, the government, and the wider community.

The previous studies present diverse results from each independent variable examined. Research in Indonesia that links board members to earnings quality has been conducted by Kontesa, Lako, and Wendy (2020) which underlines the education and experience of board members by including controlling shareholders as a moderating variable. In contrast to this study, this paper aims to examine corporate governance mechanisms on earnings quality and uses a firm's size as a moderating variable. Looking at the prior study, it is determined four variables that represent corporate governance mechanisms, namely independent commissioners, audit committees, managerial ownership, and institutional ownership. These four variables are often used by researchers and show inconsistent outcomes, among others independent commissioners are positively associated with earnings quality. (Alves, 2014; Buana & Wahyudin, 2016; Reskino, 2015), independent commissioners correlate negatively toward earnings quality (An, 2017), independent commissioners do not affect earnings quality (Chaharsoughi & Rahman, 2013; Aishah Hashim & Devi, 2008). The audit committee has a positive effect on earnings quality (Oktaviani, Nur, & Ratnawati, 2015), the audit committee has a negative effect on earnings quality (Azzoz & Khamees, 2016), audit committee does not affect earnings quality (Baxter & Cotter, 2009; Puspitowati & Mulya, 2014). Managerial ownership proves a positive effect on the earnings quality (Ayadi & Boujelbene, 2014; Oktaviani et al., 2015), meanwhile the research conducted by Puspitowati and Mulya (2014) and Riswandi (2014) show that managerial ownership affects negatively toward earnings quality, managerial ownership does not affect earnings quality (Chaharsoughi & Rahman, 2013; Aishah Hashim & Devi, 2008). The relationship between institutional ownership and earning quality also has a debatable conclusion. Ayadi and Boujelbene (2014) and Buana and Wahyudin (2016) provided a positive effect, otherwise, Puspitowati and Mulya (2014) showed a negative association.

## 2.2. Hypotheses development

Independent commissioners have an important role in the internal control mechanism that exists in the company, with their presence indicating that the monitoring in the company is running effectively. Improving the quality of this monitoring will encourage better financial reporting to encourage increased earnings quality. Legitimacy theory examines the relationship of a company to the community that can be used as a basis for the relationship between independent commissioners and earnings quality. This theory states that an organization or company will continue to operate if the company can assure its activities and performance so that it is accepted by the public. The company will use annual reports to report its performance and responsibilities. Commissioners who come from outside the company have the strength and role in paying attention to the community, in carrying out their role in the community one of them is attention to prospects through increasingly high-quality earnings. The explanation above is strengthened by the results of the studies by Alves (2014), Buana and Wahyudin (2016), and Reskino (2015) which describe that unrelated parties commissioners are able to encourage supervision so that companies can report higher quality earnings.

*H1: A higher percentage of independent commissioners is associated with increased earnings quality.*

The audit committee is a committee formed by the board of commissioners to assist in carrying out its duties and functions (Khafid, 2012). The audit committee is one of the components of corporate governance that plays an important role in the financial reporting system that will suppress the act of manipulation of financial statements. The audit committee will be in charge of assisting the board of commissioners and has the responsibility to monitor financial reporting. The presence of the audit committee will suppress the act of manipulation of financial statements so that the earnings reported by the company are more qualified. Agency theory shows that the audit committee through the board of commissioners represents the owner of the company in the monitoring process. The audit committee will assist the board of commissioners and have the responsibility to monitor the financial reporting process. It is expected that with the existence of an audit committee, the decision taken by the manager can be monitored and controlled so that it can bind all interested parties. Increasing the audit committee will increase earnings quality. The explanation above is strengthened by the results of research conducted by Oktaviani et al. (2015) which state the higher audit committee will encourage the availability of more quality profit information. Considering the review of the theory that has been presented above, it can be understood that the increasing size of the audit committee in the company can improve earnings quality.

*H2: A higher audit committee is associated with increased earnings quality.*

Hunjra, Perveen, Li, Chani, and Mehmood (2020) argue that earnings management practices may cause a decrease in the reliability of company's financial statements. This creates information asymmetry between shareholders inside and outside the company. Managerial ownership is the ownership of company's shares by managers or in other words managers are also shareholders. Managerial ownership will encourage managers' motivation and direct them to be more transparent about the financial information they report and all the decisions they make. Agency theory states that the presence of managerial ownership will align the incentives of managers (agents) and shareholders (principals) and will reduce agency costs so that costs that need to be spent by companies are lower. If the manager has shares in the company, the manager in making short-term and long-term decisions will provide the best decisions not only oriented to personal interests. It can be said that managerial ownership can maintain the balance of interests within the company, between shareholders and corporate management. Thus, the ownership of shares by the managers is expected to make them publish a qualified earning report for shareholders, namely themselves. On the other hand, if managerial ownership is low, the possibility of manager opportunistic behavior will increase.

The statement above is in line with studies directed by Ayadi and Boujelbene (2014) and Oktaviani et al. (2015), the results of the studies indicate that managerial ownership positively affects earnings quality. The greater the managerial ownership in the company, the management will tend to try to increase the performance and quality of financial reporting; this will certainly encourage higher qualified earnings. Considering the previous explanation, they implied that increasing the percentage of managerial ownership will enlarge earnings quality.

*H3: A higher percentage of managerial ownership is associated with increased earnings quality.*

Institutional ownership is the amount of a company's available stock owned by other entities/external institutions, such as banks, insurance companies, investment firms, private foundations, and other institutions. The existence of institutional ownership is expected to increase monitoring of the performance of company management to create a more productive company. Monitoring carried out by institutions openly is conducted through the implementation of good corporate governance. Institutional investors tend to actively monitor the funds invested because of the high level of wealth invested and their orientation to the profits to be gained in the future.

The agency theory describes an institution as an agent and management as a principal, the presence of the institution as a shareholder has a huge effect on the organization. The investor institutions have the ability to reduce the negative behavior of managers through intensive supervision. The owners who come from institutions are considered capable of monitoring every event that occurs in the company and are more responsive if there are changes in the company. The statement above is supported by the results of the studies conducted by Ayadi and Boujelbene (2014) and Buana and Wahyudin (2016), who find that institutional ownership has a positive effect on earnings quality. Thus, it can be understood that the greater the ownership of shares by institutions, earnings quality will increase.

*H4: There is a positive relationship between institutional ownership and earnings quality.*

Studies on the association between independent commissioners and earnings quality have been carried out beforehand and have shown inconsistent results. Reskino (2015) finds that the unrelated parties commissioners are able to improve earnings quality. An (2017) reveals that the higher the number of outsider commissioners, it will reduce profits quality, meanwhile, Aishah Hashim and Devi (2008) state that independent commissioners are unable to explain earnings quality. The importance of the firm's size has been emphasized in previous literature that is associated with cash holding (Ballas, Hevas, Karampinis, & Vlismas, 2021). Kent, Kent, Routledge, and Stewart (2016) conduct research that presents the firm's size as a cluster to divide research samples. The results of the study are the first (largest) cluster companies having the largest percentage of independent commissioners implementation and the highest earnings quality. This implies that the firm's size needs to be considered as a variable that moderates the effect of independent commissioners on earnings quality.

The legitimacy theory states that a company must maintain its legitimacy in the community to be able to continue its operations. Large companies tend to be more careful in releasing various information about the company because the larger the company, the higher the public's attention to it. A high level of caution in a company encourages aspects that need to be monitored by the company more broadly so that more independent commissioners are needed. The number of independent commissioners determined and adjusted to their capacity will certainly improve the performance of independent commissioners so that the supervision process runs well and the reported earnings will have higher quality. Based on the explanation above, it is understood that the company's size can moderate the relationship between independent commissioners and earnings quality.

*H5: The firm's size moderates significantly the relationship between independent commissioners and earnings quality.*

Previous research concerning the audit committee on earnings quality has been done before. Ayadi and Boujelbene (2014) and Oktaviani et al. (2015) proved that an increasing number of audit committees lead to improve the quality of profit. In contrast, Azzoz and Khamees (2016) found that the audit committee and earnings quality have a negative association, whereas Reskino (2015), states that the audit committee does not influence earnings quality. Kent et al. (2016) state that relatively medium and large companies tend to implement audit committees compared to smaller companies and have higher earnings quality. This implies that the company's size can be considered to moderate the effect of the audit committee on earnings quality.

Legitimacy theory states that large companies tend to be more considered by companies. Hence, larger companies are more careful in the process of publishing information about the company. The audit committee has a high role in various information released by the company, they are in charge of reviewing various information and ensuring its accuracy. The larger the size of the company, the information reported by the company will be more extensive so this will encourage the need for a larger number of audit committees. On the other hand, a larger firm's size will have greater assets; this can support the company's operations more effectively to maximize the profits derived. High profits and supported by good supervision by the audit committee will minimize the opportunity for negative actions such as manipulation of financial statements so that this will improve the quality of the company's earnings. In line with the above arguments, we formulate the following hypothesis:

*H6: The firm's size moderates significantly the relationship between the audit committee and earnings quality.*

Research conducted by Ayadi and Boujelbene (2014) and Oktaviani et al. (2015) show that managerial ownership positively affects earnings quality. Puspitowati and Mulya (2014) and Riswandi (2014) find that managerial ownership has a negative effect on earnings quality, whereas Chaharsoughi and Rahman (2013) and Aishah Hashim and Devi (2008) state that managerial ownership does not affect earnings quality. Differences in the results of previous studies encourage researchers to propose a moderating variable, namely the firm's size. The agency theory states that larger companies have a higher possibility of agency problems than smaller companies. High agency problems that might occur in a company can be overcome, one of which is by equalizing the interests of management and shareholders, which is realized by increasing managerial ownership in a company. This is done because of the increased managerial ownership, management is not only as a manager, but also as a shareholder so that management tends to try harder for the interests of the company and pay more attention to the company's prospects in the future, so this can minimize negative action done by management and finally able to improve earnings quality. By focusing on the role of the firm's size, we propose the following hypothesis:

*H7: The firm's size moderates significantly the relationship between managerial ownership and earnings quality.*

Ayadi and Boujelbene (2014) find that institutional ownership has a positive effect on earnings quality. Institutional ownership has a negative effect on earnings quality (Puspitowati & Mulya, 2014). Differences in the results of previous studies encourage researchers to propose a moderating variable, namely the firm's size. Large companies are considered to have less motivation to manipulate earnings because larger companies tend to have more critical majority shareholders than smaller companies. The agency theory states that the greater the company, the greater the chance of agency conflict. Agency conflict can be minimized by the presence of an institution as a shareholder. Institutions acting as supervisors will pay attention to all actions taken by management so that management will get pressure to make more credible financial statements that will encourage higher quality reported earnings. Based on the explanation above, it is understood that the company's size has a role to moderate the influence of institutional ownership toward earnings quality.

*H8: The firm's size has a moderating role in the relationship between institutional ownership and earnings quality.*

## 3. RESEARCH METHODOLOGY

This was a quantitative research approach to investigate the determinants that affect earnings quality. The initial sample selection involved the manufacturing industries from Indonesia Stock Exchange (IDX) during the period 2013–2016. We collected secondary data from the audited financial statements published on the IDX website and official company website. The manufacturing sector was chosen because this sector is a type of business that is growing rapidly in Indonesia and has the largest number listed on the IDX, so it is considered to represent the condition of go public companies in Indonesia. This current paper covers the effect of corporate governance practices during the period 2013–2016, at least there are 2 considerations. First, in 2012 the Indonesian government issued a regulation related to indicators of assessment and evaluation of the implementation of good governance for state-owned enterprises. Second, at the end of 2016, a new regulation related to good governance for insurance companies was issued, which became effective from January 2017. Therefore, this research is in the time frame before the enactment of the new regulation. The data collection technique in this research was the documentation technique. The sample selection method used in this study was purposive sampling. The criteria of sample determination can be shown in Table 1.

**Table 1.** Criteria of research samples

| No | Company identification | Beyond criteria | Meeting criteria |
|---|---|---|---|
| 1 | Manufacture industries listed on the IDX during 2013–2016 | | 144 |
| 2 | Manufacture industries that do not publish financial reports for the period 2013–2016. | (3) | 141 |
| 3 | Manufacture industries that do not have managerial ownership and institutional ownership as well as do not make a profit in the period 2013–2016 | (121) | 20 |
| | Total sample companies used | | 20 |
| | Total research years | | 4 |
| | Total research samples | | 80 |
| | Outlier data | | (24) |
| | Total observation units | | 56 |

*Source: Data processed.*

This study investigates the association between CG mechanisms and earning quality. We also examine the moderating role of the firm's size in the research model. This paper uses the definition and measure of earnings quality based on the cash flow from operations. A study by Mikhail, Walther, and Willis (2004) concludes that the quality of the profit is reflected in the future cash flow. Furthermore, Obaid and Yasir (2020) stated that the most common and accepted term by most researchers related to the concept of earnings quality is related to cash flow from operations. The operational definition of the variables used in this study can be seen in Table 2.

**Table 2.** Operational definition of research variables

| Variables | Definition | Measurement/Indicator |
|---|---|---|
| *Earnings quality* | Earnings that correctly and accurately describe corporate operational profitability | $\frac{Cash\ flow\ from\ operation}{EBIT}$ |
| *Independent commissioner* | Parties that are not affiliated with major shareholders, members of the board of directors, and/or other members of the board of commissioners | $\frac{\sum Independent\ commissioner}{\sum Member\ of\ the\ board\ of\ commissioners}$ |
| *Audit committee* | Committees formed by the board of commissioners in order to help carry out their duties and functions | |
| *Managerial ownership* | Total shares owned by the management and company directors | $\frac{\sum Management\ shares}{\sum Outstanding\ shares}$ |
| *Institutional ownership* | The proportion of shares that are owned by other entities/external institutions, such as banks, insurance companies, investment firms, private foundations, and other institutions | $\frac{\sum Institutional\ shares}{\sum Outstaning\ shares}$ |
| *Firm's size* | A comparison of a big or small company which is one way can be seen from the size of the assets owned | $Ln\ Total\ Asset$ |

*Source: Taken from previous research (Solikhah & Winarsih, 2016; Wahyudin & Solikhah, 2017; Solikhah, Firmansyah, & Pirzada, 2017).*

We employed a linear regression model to inspect the variables included in the corporate governance mechanism that are thought to affect earning quality. To test the effect of a moderating variable, we used moderating regression analysis, an application of linear multiple regression where the regression equation contains elements of interaction. The selection of this analytical tool is based on the opinion of Russell and Bobko (1991), they proved that multiple regression is one of the most commonly accepted forms of relationships among three variables for interaction effects.

## 4. RESULTS

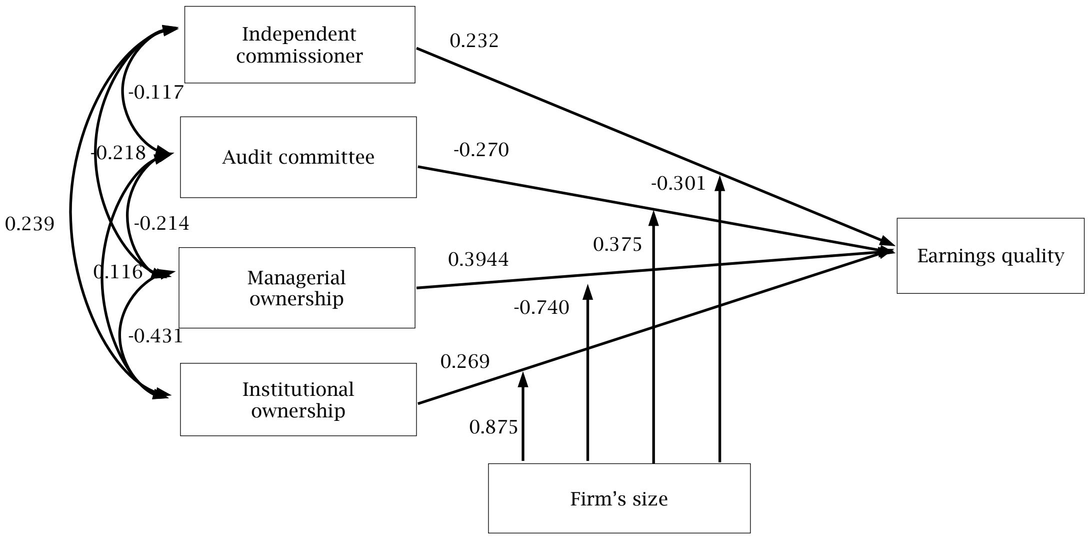
The descriptive statistical examination was performed to determine the description of each variable. The analysis used in this study contains the minimum value, maximum value, average value, and standard deviation values. The result of the descriptive statistical examination could be shown in Table 3.

**Table 3.** The results of descriptive statistics examination

| Variable | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| *Earnings quality* | 56 | -1.4340 | 4.0249 | 0.768855 | 0.8942310 |
| *Independent commissioner* | 56 | 0.3000 | 0.7500 | 0.393464 | 0.0934008 |
| *Audit committee* | 56 | 3 | 4 | 3.13 | 0.334 |
| *Managerial ownership* | 56 | 0.0001 | 0.1790 | 0.026995 | 0.0466817 |
| *Institutional ownership* | 56 | 0.0846 | 0.8811 | 0.539225 | 0.2085776 |
| *Firm's size* | 56 | 25.2954 | 31.7821 | 27.876684 | 1.5708843 |

*Source: Data processed employing 20 manufacturing companies during 2013–2016.*

**Figure 1.** The result of moderating regression test




The classical assumption test used in this model includes the normality test, autocorrelation test, heteroscedasticity test, and multicollinearity test. The normality test showed that the residual is normally distributed, the significance value listed is 0.069, this value is above 0.05. The multicollinearity test demonstrated a VIF value less than 10 and tolerance value > 0.01 so that it can be interpreted that in this study among the independent variables are not highly correlated. The heteroscedasticity examination done using the Gletser test showed that all the variables have a significance value of more than 0.05. Thus, it can be concluded that the residual is homoscedastic. The autocorrelation testing is performed using a run test and the significance value is 0.177, above 0.05. So, it can be concluded that autocorrelation does not arise.

The adjusted R-squared value is 0.254, which means that the effects of independent commissioners, audit committee, managerial ownership, and institutional ownership as well as company size as a moderating variable on earnings quality are 25.4% and the magnitude of other variables that affect the earnings quality variable is 74.6%. Figure 1 and Table 4 depict the results of the eight hypotheses examination.

**Table 4.** Results of hypothesis testing

| *No* | *Hypothesis* | *Regression coefficient* | $t_{count}$ | *Sig* | *Decision* |
|---|---|---|---|---|---|
| *H1* | A higher percentage of independent commissioners is associated with increased earnings quality. | 0.232 | 1.908 | 0.063 | Rejected |
| *H2* | A higher audit committee is associated with increased earnings quality. | -0.270 | -1.045 | 0.301 | Rejected |
| *H3* | A higher percentage of managerial ownership is associated with increased earnings quality. | 0.394 | 2.397 | 0.021 | Accepted |
| *H4* | There is a positive relation between institutional ownership and earnings quality. | 0.269 | 2.135 | 0.038 | Accepted |
| *H5* | The firm's size moderates significantly the relationship between independent commissioners and earnings quality. | -0.301 | -1.497 | 0.141 | Rejected |
| *H6* | The firm's size moderates significantly the relationship between the audit committee and earnings quality. | 0.375 | 1.371 | 0.177 | Rejected |
| *H7* | The firm's size moderates significantly the relationship between managerial ownership and earnings quality. | -0.740 | -3.059 | 0.004 | Accepted |
| *H8* | The firm's size has a moderating role in the relationship between institutional ownership and earnings quality. | 0.875 | 3.380 | 0.001 | Accepted |

*Source: Data processed employing 20 manufacturing companies during 2013–2016.*

## 5. DISCUSSION

### 5.1. The effect of independent commissioners on earnings quality

The results of the hypotheses testing in Table 4 show that *H1* is rejected, meaning that the independent commissioner does not affect earnings quality. Based on the results of the study, it is concluded that independent commissioners and audit committees have no significant influence on earnings quality. The existence of independent commissioners and audit committees in the companies is less maximized so that the supervisory function is not effective. The results of this study are consistent with the theory of stewardship, this theory examines that managers are stewards who seek to maximize performance and operations in the company rather than as agents who take opportunities and are oriented towards personal gain. Thus, the presence or absence of independent commissioners in the company does not affect the manager's performance. The results of this study are consistent with research conducted by Aishah Hashim and Devi (2008) and Chaharsoughi and Rahman (2013) which state that independent commissioners have no significant effect on earnings quality. In contrast with findings from Nurdiono et al. (2019), who confirm that independent commissioners significantly increase the independence of the board of commissioners, they act more effectively in meeting the interests of the company and all shareholders.

### 5.2. The effect of the audit committee on earnings quality

The results of the hypotheses testing in Table 4 show that *H2* is rejected, meaning that the audit committee does not affect earnings quality. The results of this study are in line with the theory of stewardship that the audit committee has a duty to represent the board of commissioners in the process of corporate management supervision. In this theory, the manager as a steward will move to meet the wishes of the principal, have high loyalty, and strive to achieve corporate goals without the need for supervision and pressure from the audit committee. This is in line with the research conducted by Baxter and Cotter (2009) and Puspitowati and Mulya (2014) that the audit committee does not affect earnings quality. This finding in Indonesian companies is also in line with research conducted in Egypt by Boghdady (2019). He found that a larger audit committee does not necessarily improve the quality of financial reporting and does not limit the manipulation of discretionary spending in Egyptian companies.

The selection of the audit committee conducted by the board of commissioners is considered not independent. There is a large influence from the controlling shareholders so that the determination of the audit committee is not based on the ability and expertise of the prospective members, but the recommendation of the shareholders so that the audit committee is not able to maximize its duties. In contrast to the results, research by Sae-Lim and Jermsittiparsert (2019) shows that audit committees are able to limit earnings management activities in companies.

### 5.3. The effect of managerial ownership on earnings quality

The results of the hypotheses testing in Table 4 show that *H3* is accepted. That is, managerial ownership has a positive effect on earnings quality. Share ownership by management will encourage managers to further improve performance to make profits rather than manipulate data to obtain high profits. The managers will be more concerned about the company's future and not just oriented towards personal interests. This finding supports the analysis of Nguyen, Duong, and Narendran (2020) that personal characteristics of chief executive officers (CEOs) have an effect on earnings quality, the relationship will be more pronounced when CEOs have high equity-based compensation incentives. Finally, it helps to improve earnings quality reported by the companies. This is in line with the agency theory that managerial ownership will reduce the opportunistic nature of managers, thereby minimizing opportunities for financial manipulation so that earnings quality will improve. The same research results revealed by Ayadi and Boujelbene (2014) and Oktaviani et al. (2015), which state that managerial ownership has a positive effect on earnings quality.

### 5.4. The effect of institutional ownership on earnings quality

The results of the hypotheses testing in Table 4 show that *H4* is accepted. That is, institutional ownership has a positive effect on earnings quality. The presence of institutions in a company will have a considerable influence. This is due to that the institution will supervise and control the company considering the high amount of funds invested in the company so that it will encourage management to work more productively and transparently and ultimately will improve earnings quality reported by the company. The results of this study are in line with Ayadi and Boujelbene (2014) and Buana and Wahyudin (2016), who state that institutional ownership has a positive effect on earnings quality. This study confirms the results of research by Hunjra et al. (2020), who found institutional ownership has a significant positive impact on stock market liquidity, which supports signal theory because institutional owners can monitor managers in the company. The results of this study have been aligned with agency theory. In this theory, an institution acts as an agent and managements as principals. The presence of the institution as a shareholder has a great influence on the company. Institutions that act as agents have the ability to reduce the negative behavior of managers through intensive supervision so that the reported profit is getting qualified.

### 5.5. The firm's size moderates the effect of independent commissioners on earnings quality

The results of the hypotheses testing in Table 4 show that *H5* is rejected. That is, the company's size is not proven to moderate the influence of independent commissioners on earnings quality. The failure of the influence of independent commissioners on earnings quality leads to the insignificant role of the firm's size moderation in this relationship. The opinion of Mutunga and Owino (2017) that bigger firms are presumed to be more efficient than smaller ones failed to prove. The results of this study indicate the inability of the firm's size to be a moderating variable, so the assumption that a larger company will assign more independent commissioners cannot be proven. Stewardship theory explains that management is essentially trustworthy, and acts as well as possible, full of responsibility and honesty so that the size of the company will not affect the company's performance or financial reporting process. Management in large companies and smaller companies will maximize their ability to earn profits and provide the best information to stakeholders so that higher supervision by an independent commissioner is not needed by the company. The explanation above means that the changes in earnings quality do not influence the changes in the number of independent commissioners and the firm's size scale.

### 5.6. The firm's size moderates the effect of the audit committee on earnings quality

The hypotheses testing in Table 4 shows that *H6* is rejected. This means that the firm's size is not a moderating variable in the relationship between the audit committee and earnings quality. The results of this study indicate that the firm's size is not able to play a role as a moderating variable. In fact, the firm scale does not differ in the relationship between audit committees and earnings quality. This finding is in line with the rejection of *H2* where the audit committee has no effect on earnings quality (Boghdady, 2019). Stewardship theory explains that management is essentially trustworthy, and acts as well as possible, full of responsibility and honesty so that the size of the company will not affect the company's performance or financial reporting process. Management in large companies and smaller companies will maximize their ability to earn profits and provide the best information to stakeholders so the company's need for a higher audit committee is not considered too much because management is considered to have provided information that reflects the real situation. The previous explanation shows that earnings quality is not explained by the increase or decrease in the number of the audit committee and firm's size scale.

### 5.7. The firm's size moderates the effect of managerial ownership on earnings quality

The results of the hypotheses testing in Table 4 show that *H7* is accepted. That is, the firm's size significantly moderates the effect of managerial ownership on earnings quality. Looking at the value of the regression coefficient, the presence of moderation weakens the relationship between managerial ownership and earnings quality. As the size of the company increases, the number of shares owned by the company will be even greater. On the other hand, the larger the company, investors will be more interested in investing their shares because large companies are considered more stable. Increasing the number of shares outstanding and investors from outside the company will reduce the existing managerial ownership in the company, the low managerial ownership, earnings quality will also be lower. This finding empirically proves that the size moderates (weakens) the influence between managerial ownership on earnings quality. This finding is consistent with the study by Mutunga and Owino (2017), they confirm that the firm's size positively moderates the relationship between production capacity, management practices, operational practices, and firm financial performance.

### 5.8. The firm's size moderates the effect of institutional ownership on earnings quality

The results of the hypotheses testing in Table 4 show that *H8* is accepted. That is, the firm's size significantly moderates the effect of institutional ownership on earnings quality. Looking at the regression coefficient, the presence of the firm's size strengthens the effect of institutional ownership on earnings quality. These results support the consensus that institutional investors are motivated to obtain both financial and social returns (Dyck, Lins, Roth, & Wagner, 2019). The opinion of Hunjra et al. (2020) is that institutional shareholders have the motivation to monitor the activities of managers to avoid agency conflicts. The significance of the firm's size in strengthening the influence of institutional ownership on earnings quality is reinforced by the opinion of Hunjra et al. (2020), the ability of institutional investors to influence business decisions depends on the size. Company size helps in achieving economies of scale (Mutunga & Owino, 2017).

The agency theory states that the greater the company, the greater the chance of agency conflict. Agency conflicts can be minimized, one of which is by the presence of institutions as shareholders. Institutions that also act as supervisors will pay attention to all actions taken by management so that this will suppress the emergence of managerial opportunist attitudes that cause agency conflicts. Besides, large companies are considered to have less motivation to manipulate earnings because larger companies tend to have more critical majority shareholders compared to smaller companies. The majority shareholders, one of which is the institution, has great pressure on the company because the institution is more active in supervising the company and has voting rights on the company so that it will minimize the act of manipulation of financial statements, so the larger the company, the better earnings quality.

## 6. CONCLUSION

This paper shows the empirical result on earnings quality in a developing country. The effect of the independent commissioner, audit committee, managerial ownership, and institutional ownership on earnings quality has been discussed. The important issue of this study is that the firm's size is able to moderate the effect of managerial ownership and institutional ownership on earnings quality. In general, manufacturing companies in Indonesia show high-quality earnings performance based on cash flow. This finding supports the most commonly accepted mechanism on the concept of earnings quality (Lyimo, 2014), where indicated by the lower operating cash flows than earnings before interest and taxes.

Managerial ownership has a positive effect on earnings quality. Companies with high managerial ownership will reduce agency conflict so they tend to have high qualified earnings. Institutional ownership has a positive effect on earnings quality. Institutional shareholders can restrain the opportunist nature of managers in managing earnings. Owners and shareholders act as principals where they are considered only interested in the finances and profits generated by the company, while management in the company act as agents where they are interested in the provision of compensation and bonuses for their performance. This relationship between management and owners will cause agency problems such as increasing information asymmetry between the two parties. This problem is known as agency conflict which can actually be minimized by imposing corporate governance mechanisms. The firm's size moderates significantly the effect of managerial ownership on earnings quality. The interest of investors from outside the company will increase as the company grows, causing shareholders from management increasingly powerless. The firm's size moderates significantly the effect of institutional ownership on earnings quality. Large companies are considered to have less motivation to manipulate earnings because larger companies tend to have a more critical majority shareholder compared to smaller companies. On the other hand, the firm's size is not able to moderate the effect of independent commissioners and audit committees on earnings quality. Managers have high loyalty to the company without considering how big the company they work for. It is suggested that a comparison between cash flow from operation and EBIT is an easy way to assess earnings quality.

The findings provide significant implications for practitioners, academicians, and policymakers. This study contributes to the existing literature on how corporate governance attributes affect the earning quality based on cash flow and differ in the firm's size. The evidence shows that managerial ownership and institutional ownership are associated with earnings quality, the results imply that investors may consider these two variables to choose a portfolio of stock in the capital market. To make investment decisions and monitor earnings quality, (potential) investors should consider the quality of income ratio by paying attention to cash flow from operations.

This paper is limited to manufacturing companies listed on the IDX. Further researchers can expand research in all sectors, even compare earnings quality in several countries. Suggestions for further research should consider the other corporate governance mechanisms variables such as the board of commissioners, board of directors, independent audit committee, concentrated ownership, and foreign ownership.

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