

Factors in Measuring the Earning Quality in the Consumption Industry of Public Companies

1st Dedi Putra

Economic and Accounting Department
Institute Informatika and business
Darmajaya, Lampung
Indonesia
Email : dedi.putra@darmajaya.ac.id

2nd Pebrina Swissia

Economic and Accounting Departemen
Institute Informatika and business
Darmajaya, Lampung
Indonesia
Email :
pebrinaswissia@darmajaya.ac.id

3rd Mutiara Dwi Firdiana

Economic and Accounting Department
Institute Informatika and business
Darmajaya, Lampung
Indonesia
Email : mutiara6899@gmail.com

Abstract- *The purpose of this study was to empirically find the effect of reporting timeliness, default risk, and the audit committee on earnings quality in consumer goods industrial sector companies listed on the IDX in 2016-2019. The data in this study used secondary data in the form of annual financial reports and annual reports for 2016-2019. The method of data collection used the purposive sampling technique. The population in this study was the consumer goods industry sector companies listed on the IDX in 2016-2019. The number of samples was 21 companies. The data analysis technique used the multiple linear regression analysis with SPSS software version 22. The result of this study found that the timeliness of reporting and the audit committee variables had no significant effect on earnings quality. Meanwhile, the default risk had a significant effect on the earnings quality.*

Keywords- *Earnings quality, Timeliness of Reporting, Default Risk, Audit Committee*

I. INTRODUCTION

In this increasingly advanced era, various information can be easily obtained. An information is said to be informative if the information can change the *belief* of investors in making investment decisions. The importance of earnings information is stated in *Statement of Financial Accounting Concept* (SFAC) No. 1 which states that earnings have benefits for assessing management performance, helping to estimate the ability of earnings in the long term, as well as being able to predict profits and assess risk in investment or credit. For investors themselves, information from

the company is the basis in making decisions to invest. Earnings quality is the quality of earnings information available to the public that is able to show the extent to which earnings can influence decision making and can be used by investors to assess the company [1].

Earnings quality can be influenced by many factors, including the following: timeliness of reporting, *default risk*, and audit committee. Timeliness of reporting is a reflection of the quality of the company's performance which can reflect the credibility or quality of accounting information (including earnings information) reported [2]. The delay in reporting time will have an impact on the decisions of investors who become doubtful due to increased uncertainty. Therefore, the more timely the company submits its financial statements, the higher the quality of earnings proxied by ERC [3].

Default risk is the company's failure to pay interest or loan principal at the right time [4]. Companies that have high debt values can provide an increase in profits that can strengthen the position and security of *bondholders* compared to shareholders. The impact will affect the decision-making situation by investors who are increasingly careful in making decisions related to companies that have high risk [2]. The audit committee is a committee that works professionally and independently and is formed by the board of commissioners. The role of the audit committee is very much needed because the existence of an audit committee is expected to improve earnings quality through supervision of the financial reporting process [5]. The more number of audit committees a company has, the better protection and control over the accounting and financial processes. So that management can issue financial reports with reliable earnings quality.

From the results of several previous studies, indicating that there is a *research gap* on the variables of reporting timeliness, *default risk*, and the audit committee on earnings quality, research [2] concludes that reporting timeliness and *default risk* have no effect on earnings quality. Meanwhile, *political connection* has a negative effect on earnings quality. Research [6] concludes that timeliness affects earnings quality. Research [7] which concludes that the risk of debt failure affects earnings quality and is statistically significant. Research [8] which concludes that the audit committee has a positive and significant effect on earnings quality. And research [9] which concludes that the audit committee has no effect on earnings quality.

The consumer goods industrial sector was chosen because this sector is one of the sectors of manufacturing companies that play an active role in the Indonesian capital market. The development of the consumer goods industry in Indonesia has increased significantly from year to year. This is indicated by the large number of investors who are interested in investing their shares in the consumer goods industry sector. Thus the more the company increases, the higher the management of the company will be.

II. LITERATURE REVIEW

A. Signaling Theory (*Signaling Theory*)

Signal theory was first coined by Michael Spence (1973) in his research entitled *Job Market Signaling*. *Signaling theory* is the shareholder's perspective on the company's opportunities to increase the value of the company in the future, where the information is provided by the company's management to shareholders [10]. *Signaling theory* or signal theory explains why a company has the urge to provide financial statement information to external parties. This makes *signaling theory* emphasizes the importance of information issued by the company which can then be used for investment decisions from outside the company.

B. Earnings Quality

Earnings quality according to [11] in his book, "*Earnings Quality refers to the relevance of earnings in measuring company performance*". Earnings quality is earnings in the financial statements that reflect the actual financial performance of the company [5].

The *earning quality* ratio shows the relationship between cash flow and net income, the higher the

ratio the higher the earnings quality because the larger the portion of operating profit realized in cash and not on an accrual basis. Earnings quality is based on the earnings-cash-accrual relationship which is measured using the ratio of operating cash to earnings, which is indicated by operating cash flow. Earnings that are closer to operating cash flows indicate that the earnings are of higher quality [12].

C. Reporting Timeliness

Timeliness is the availability of information to decision makers when needed before the information loses its power to influence decisions. Relevant information will be useful for users if it is timely before users lose the opportunity or ability to influence decisions to be taken (IAI, 2015). Timeliness is one way to measure the transparency and quality of financial reporting. Timeliness is one of the supporting elements for the quality of financial reports [13].

D. Default risk

Default risk is the company's failure to pay the interest or principal on the loan in a timely manner. Default risk is something that investors pay great attention to [4]. The risk of failure is the use of debt and assets by companies that have fixed costs to increase investors' potential profits. Although companies with high risk can promise high returns, on the other hand, the level of uncertainty is also high [14]. *Default risk* reflects the high level of corporate debt, so it can be seen that the quality of the company in the future will be in an unfavorable situation [15]. *Default risk* is proxied by using a measure of the level of *leverage*. *Leverage* is a ratio that measures the ability of both long-term and short-term debt to finance company assets [16].

E. Audit Committee

The audit committee is a group of people who are selected by a larger group to carry out certain jobs or to perform special tasks or a number of members of the client company's board of commissioners who are responsible for assisting the auditor in maintaining his independence from management. The audit committee is tasked with assisting the board of commissioners to monitor the financial reporting process by management to increase the credibility of the financial statements. The audit committee's duties include reviewing the accounting policies applied by the company, assessing internal controls, reviewing external reporting systems and compliance with regulations [17].

The existence of the Audit Committee is regulated through Bapepam Circular Number: SE/03 PM/2002 (for public companies) and the Decree of the Minister of BUMN Number: Kep-103/MBU/2002 (For BUMN) The Audit Committee consists of at least three people, chaired by a Commissioner Independent company with two independent external people who master and have accounting and finance background.

F. HYPOTHESIS BUILDING

The Effect of Timeliness of Reporting on Earnings Quality

Timely reporting will provide a good signal (*good news*) to investors towards the company, because timely reporting shows that the report does not contain *noise* or interference so that investors will judge the earnings quality. This is in line with research [6] which concludes that timeliness affects earnings quality. Based on this description, the following research hypotheses are proposed:

H1 : Timeliness of Reporting has a significant effect on Earnings Quality.

Effect of Default Risk on Earnings Quality

Default risk is the company's failure to pay the interest or principal on the loan in a timely manner. *Default risk* is proxied by using a measure of the level of *leverage* . The higher the level of corporate *leverage*, the lower the quality of the company's earnings. In accordance with signal theory, companies with high levels of *leverage* cause investors to have less confidence in earnings information published by companies [5]. This is in line with research [7] which states that the risk of debt failure affects earnings quality and research [18] which concludes that *leverage* has a significant effect on earnings quality. Based on this description, the following research hypotheses are proposed:

H2: Default Risk has a significant effect on Earning Quality.

Influence of the Audit Committee on Earnings Quality

The more number of audit committees a company has, the better protection/protection and control over the accounting and financial processes will be. With a larger number of audit committees in a company , if a problem occurs, the audit committee will be able to solve the problem easily. The company will show a signal that the performance of a good audit committee will improve the quality of the profits generated by the company [5]. This is in line with research [8] which states that the audit committee has a positive and significant effect on earnings quality. Based on this description, the following research hypotheses are proposed:

H3 : The Audit Committee has a significant effect on Earnings Quality.

III. RESEARCH METHODS

The population used in this study are all consumer goods industrial sector companies listed on the IDX in 2016-2019. This study uses a sampling method in the form of *non-probability sampling* with *purposive sampling technique* as the type of sampling.

A. DEFINITION OF VARIABLE OPERATING

Earnings Quality

In this study, earnings quality is proxied by *Earning Quality* [19]. Where earnings quality is measured by the ratio between cash flow from operations divided by *Earnings Before Interest and Taxes* (*EBIT*) or income/earnings before interest and taxes . The greater the ratio, the better the earnings quality, with the following formula:

$$Earning\ Quality = \frac{CFO}{EBIT}$$

Reporting Timeliness

Bapepam Regulation Number XK2, Attachment to the Decree of the Chairman of the Capital Market and Financial Institution Supervisory Agency Number: KEP346/BL/2011 concerning the submission of periodic financial reports of issuers or public companies states that annual financial reports must be accompanied by an Accountant's report in the context of auditing financial statements. The annual financial report must be submitted to Bapepam and LK and announced to the public no later than the end of the third month (90 days) after the date of the annual financial report (end of the financial year). However, for the 2019 annual financial report, the Indonesia Stock Exchange (IDX) provides relaxation to issuers or public companies due to the impact of the Covid-19 outbreak, the Financial Services Authority (OJK) provides relaxation regarding the submission of financial reports and holding a general meeting of shareholders, related to the status of COVID-19 emergency. According to the Decree of the Board of Directors of the Indonesia Stock Exchange No. Kep-00057/BEI/08-2020, Regarding Relaxation of Deadline for Submission of Annual Financial Reports, Quarter I Financial Reports, Mid-Annual Financial Reports and Annual Reports stipulates that the deadline for submitting Annual Financial Statements and Company Annual Reports is extended for 2 (two) months from the deadline for submitting the report.

In this study, timeliness of reporting is measured using a *dummy* variable [20] with the category being for companies that are on time given a value of 1 and companies that are not on time (late) are given a value of 0.

Default Risk

Default risk in this study is proxied by using a measure of the level of *leverage* [5]. The calculation of the *leverage* ratio used is based on the total value of debt and total assets as follows:

$$LEV = \frac{\text{Total Utang}}{\text{Total Assets}}$$

Audit Committee

The audit committee is tasked with assisting the board of commissioners to monitor the financial reporting process by management to increase the credibility of financial reports [17]. The audit committee in this study was measured using the number of audit committee members in the company [9] as follows:

KA = Number of the company's audit committee.

IV. RESULTS AND DISCUSSION

The results of the normality test using the one sample Kolmogorov-Smirnov test presented in the table above show that the Kolmogorov-Smirnov significant value is 0.200. With a significant value for the dependent variable in the Kolmogorov-Smirnov test obtained $0.200 > 0.05$ indicating H_0 is accepted and the data is normally distributed. Based on the multicollinearity test in the table above, the results of the VIF calculation show that the variables of reporting timeliness, default risk, and the audit committee have a VIF value of less than 10 and a tolerance of more than 0.10. This shows that there is no correlation between the independent variables or there is no multicollinearity. Based on the results of the autocorrelation test, the DW value was 1.383 with $k = 3$ and $N = 73$ values obtained $dL = 1.5645$ and $dU = 1.6768$. It can be concluded that the value of $DW < 4-DU$ or $1.383 < 2.3231$, so it can be concluded that there is no autocorrelation symptom in the data used. Heteroscedasticity test results using the glejser test described in the table above show that all test variables do not contain heteroscedasticity because the significant value is > 0.05 . So it can be concluded that this regression model has met the assumption of heteroscedasticity. This shows that the variation of the data is homogeneous. In the *summary* model, the *R square* value of 15.9% variation or change in Earnings Quality can be explained by Timeliness of Reporting, *Default Risk*, and the Audit Committee. The remaining 84.1% is influenced by

other variables not examined in this study. Based on the table anova, the significant coefficient results show that the significant value is $0.007 < 0.05$ with an F count of 4.360. This means that the model is feasible to use for research and also means that the regression model can be used to predict earnings quality or it can be said that reporting timeliness, *default risk*, and the audit committee together have a significant effect on earnings quality.

Based on the results of the t statistical test above, it is known that: (1) Reporting Timeliness (X1) is 0.284, which means it is greater than 0.05, so it can be concluded that H_1 ; rejected, meaning that the Timeliness of Reporting variable has no effect on Earnings Quality. (2) *The Default Risk* (X2) is 0.010, which means it is smaller than 0.05, so it can be concluded that H_2 ; accepted, meaning that the *Default Risk* variable has an effect on Earnings Quality. (3) The Audit Committee (X3) is 0.143, which means it is greater than 0.05, so it is concluded that H_3 ; rejected, meaning that the Audit Committee variable has no effect on Earnings Quality.

DISCUSSION

The Effect of Timeliness of Reporting on Earnings Quality

The results showed that the timeliness of reporting variables had no effect on earnings quality, so the first hypothesis was rejected. The results of this study can be seen in the data of this study, the variable timeliness of reporting by 45% shows that of the entire sample only 45% report financial statements in a timely manner, which means that there are still many companies that are late in reporting financial statements and have no effect on the quality of their earnings. Timeliness is the quality of the availability of information when needed. However, this also still depends on the reaction of investors who see other factors in the financial statements besides the timeliness of reporting [2]. The results of this study are in line with research [2] which also shows that timeliness of reporting has no effect on earnings quality.

Effect of Default Risk on Earnings Quality

The results showed that the *default risk* variable had an effect on earnings quality, so the second hypothesis was accepted. In this study, the *default risk* is proxied by using a *leverage* measure. Based on the results of data processing through SPSS, it can be seen that the results of the t test show that *default risk* has a significant negative effect on earnings quality. This is evidenced by the value of the coefficient *default risk (leverage)* is negative 0.796 with a t value of -2.667 and a significance value of $0.010 < 0.05$, which means that the higher the level of corporate *leverage*, the lower the

quality of the company's earnings. In accordance with signal theory, companies with high levels of *leverage* cause investors to have less confidence in earnings information published by companies [5]. The results of this study are in line with research [18] and [7] which conclude that *leverage*.

Influence of the Audit Committee on Earnings Quality

The results showed that the audit committee variable had no effect on earnings quality, so the third hypothesis was rejected. This study shows that the sample companies have at least 3 members of their audit committee and only a few have audit committees of 4 people. Few or many audit committees in the sample companies do not affect the quality of earnings. It is possible that the existence of an audit committee within the company is only a formality to implement Bapepam regulation Number: SE/03 PM/2002 (for public companies) and Minister of BUMN Decree Number: Kep-103/MBU/2002 (for BUMN). the number of audit committees does not guarantee that audit committee members have expertise in their fields, so the supervisory role of the financial reporting process is less effective [21]. The results of this study are in line with research [9] which shows that the audit committee has no effect on earnings quality.

V. CONCLUSIONS

This study aims to empirically examine the effect of reporting timeliness, *default risk*, and audit committee on earnings quality in consumer goods industrial sector companies listed on the IDX in 2016-2019. The data used in this study is secondary data in the form of annual financial reports and annual reports for 2016-2019 and the data collection method using the *Purposive Sampling* technique and obtained 21 companies. Based on the results of the research described in the previous chapter, the conclusions that can be drawn are as follows: [a] Timeliness of Reporting does not affect the Quality of Earnings in manufacturing companies in the consumer goods industry sector listed on the IDX for the 2016-2019 period. [b] *Default Risk* affects Earnings Quality in manufacturing companies in the consumer goods industry sector listed on the IDX for the 2016-2019 period. [c] The Audit Committee has no effect on Earnings Quality in manufacturing companies in the consumer goods industry sector listed on the IDX for the 2016-2019 period.

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