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Earnings Quality: The Role of Owners

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ABSTRACT

This study aim of analyzing the effect of ownership structure consisting of concentrated ownership, institutional ownership and foreign ownership on earnings quality. This study analyzes the effect of concentrated ownership, institutional ownership and foreign ownership on the earnings quality of Manufacturing Companies listed on the IDX in 2014-2020, and a sensitivity test by comparing different measurement of earnings quality, new and existing. By using STATA in statistical analysis, this study found a negative effect of institutional ownership on earnings quality, meaning that the role of institutional owners encourages management to reducing the earnings quality. The opposite result is found where foreign ownership has a positive effect on earnings quality, shareholders who are foreign people or agencies encourage management to provide earnings quality. Concentrated ownership was not found to have an effect on earnings quality. The results have practical implications for investors in making investment policies where the level of ownership, especially institutional owners and foreign owners. The results of this study also have theoretical implications regarding ownership structure and earnings quality prepared in financial reports by management. This study uses a new measurement as earnings quality, namely Performance Adjusted Accrual including Tax (PAiT) by adding tax elements, compared to the existing measurement, namely Performance Adjusted Dcretionary Accrual (PAccr), in the sensitivity test it was found that the use of PAiT was better than PAccr, meaning that taxes have a role in earnings quality.

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1. INTRODUCTION

Financial statements are a means for investors in assessing management performance, profit information is used by investors in investment policies (Anwaar, 2016; Pernamasari, 2020), although still limited to technical analysis (Utami et al., 2017). Even so, sometimes financial information is even misleading (Sari and Febriyanto, 2019), so that quality earnings are needed (Shahzad et al., 2019). Quality financial reports are financial reports that can help investors predict returns, which in turn improves company performance (Duarte et al., 2022). Many cases of bad information about modified or manipulation of financial reports, e.g. Enron in USA, KAI in 2006, KAEF in 2001, GIJA in 2018, Jiwasraya from 2006 to 2007, INAF on 2004, MYRX on 2016, and many others (Sandria, 2021).

Each company policy has an impact on the financial reports used by internal and external parties. Therefore, financial information must provide reliable information so that it can be used appropriately by investors (Tarmidi et al., 2021), creditors, and other potential users in investment activities and lending and business cooperation. As a principal, the owner of the company has the power to influence management over any policies taken (Karamanou and Vafeas, 2016; Tessema et al., 2018). As an internal party, management also feels that many things affect management in producing earnings quality, both from economic conditions, accounting standards and other things (Nakashima, 2019)

The literature explains the relationship between ownership structure and corporate value which is built through ownership control (Mishra and Kapil, 2017), as stakeholder theory (Freeman, 1984) that policies taken by management are not only for their own interests. but also owners, however, limited space between owners and management can cause information asymmetry between the two parties as described in agency theory (Jensen and Meckling, 1976). Many studies analyse the ownership structure (Sousa and Galdi, 2016). A literature found a relationship from concentrated ownership, institutional ownership and foreign ownership with the earnings quality (Yasser et al., 2016). With concentrated ownership, the power of the largest shareholder is very high so that management is subject to its direction (Grimaldi and Muserra, 2017), but the other finds otherwise (Al-Jaifi, 2017) and use earnings management (Lassoued et al., 2017). Companies owned by institutions are also alleged to have a high supervisory role in management in managing the company so can encourages issuer management to provide earnings quality by minimizing earnings management (Alhadi et al., 2018; Potharla et al., 2021; Ramalingegowda et al., 2021), although other studies have found no effect (Yanthi et al., 2021). Foreign owners are suspected of having minimal nationalism compared to domestic owners, especially in business activities that have a profit or profit goal so its influence earnings quality and tax avoidance (Alkurdi and Mardini, 2020; Shi et al., 2020; Yulistia et al., 2020). Company size and company age were also found to have an impact on earnings quality (Agustia and Suryani, 2018; Anam and Afrohah, 2020; Purnamasari and Fachrurrozie, 2020).

Tax policy is part of management policy which has an impact on the earnings quality, especially book timing difference (Kasipillai and Mahenthiran, 2013; Tarmidi et al., 2022). This study takes steps to prove the role of tax policy on earnings quality which is influenced by ownership structure, which has not been studied in previous studies. Earnings quality in this study is measured by incorporating elements of tax policy which is a new measurement called Performance Adjusted Accrual include Tax (PAiT) which was developed from the existing measurement, namely Performance Adjusted Discretionary Accrual (PAccr).

This study attempts to re-analyze the effect of ownership structure consisting of concentration ownership, institutional ownership and foreign ownership on earnings quality, particularly the

role of tax policy used in measuring earnings quality to contribute in financial accounting and tax accounting research.

2. METHODS

This research is a causality study in which the effect of ownership structure on earnings quality is analysed. Earnings quality is an independent variable in this study, namely the informed profit value is close to the true value and without manipulation (Dechow *et al.*, 2010). The literature explains that many measurements are used in assessing earnings quality (Yasser *et al.*, 2016). To enrich the analysis of this research, earnings quality is measured by developing a new measurement adopted from the existing literature, namely Performance-adjusted discretionary accruals include Tax (PAiT) which is a development of PAccr with the consideration that taxes can be used by management in earnings manipulation (Kasipillai and Mahenthiran, 2013; Tarmidi *et al.*, 2022) while PAiT is measured by regressing total accruals from assets, revenue, PPE, ROA and DIT, then the residual regression results are absolute and multiplied by 1 (Perotti and Wagenhofer, 2014). In the sensitivity test, the regression value was compared between PAiT and PAccr, where the PAccr measurement was the same as PAiT without DIT in the regression process (Chen *et al.*, 2015; Yasser *et al.*, 2016).

While the independent variable of this study is the ownership structure consisting of concentrated ownership which is the largest share ownership proportion of issuers and is measured by dividing the largest number of shares by total shares (Yasser *et al.*, 2016). Then there is institutional ownership which is the proportion of share ownership of issuers owned by both government and private institutions (Pasaribu *et al.*, 2016) and is measured by dividing the number of shares owned by the institution by the total shares (Yasser *et al.*, 2016). And lastly is foreign ownership which is the proportion of share ownership of issuers owned by foreign citizens or foreign companies (Fanani and Hendrick, 2016) and is measured by the ratio of the number of foreign ownership to the number of shares (Idzni and Purwanto, 2017; Yasser *et al.*, 2016). The control variables are used to strengthen the fit model of the study, while those used are company size and company age (Yasser *et al.*, 2016).

The population of this study is manufacturing companies listed on the Indonesia Stock Exchange in the period 2015 – 2020. The manufacturing sector is an imperative factor in Asia, which creates the need for appropriate inputs and outputs from other sectors (Soetanto and Fun, 2015). In the Indonesian context, the government encourages the development of this industry in the escalation of the Asian Economic Community, where the manufacturing industry has made a stable contribution to GDP in recent years compared to other sectors (Soetanto and Fun, 2015). This is a good point to examine the contribution of the company's financial information, especially earnings quality in the manufacturing companies. The sample selection was done by purposive sampling method according to the research criteria, this method is suitable for use in quantitative research that does not generalize, because the data and time are specific only to manufacturing companies with the analysis year is 2015-2020.

The panel data analysis was carried out using STATA software to get good results. The advantage of using panel data is that there is more information that can be analyzed and it is more efficient. Meanwhile, the use of STATA in the analysis test is because it is easier to use in data processing, the use of syntax in the operation of each step makes it easier for users than other tools that only use tools. Fixed Effect Model (FEM) was chosen to be the best model compared to Common Effect Model (CEM) and Random Effect Model (REM) after testing the best model selection, namely Chow test, LM test and Hausman test. Then the classical assumption

test is carried out with the ordinary least square (OLS) approach in the form of heteroscedasticity test and multicollinearity test so that the data analyzed is feasible (Kuncoro, 2013).

After the data is feasible, then the F test and t test are carried out as a hypothesis test and a sensitivity test in the form of a regression test comparison between the research model that uses the new measurement and the existing measurement in earnings quality indicators.

3. RESULTS AND DISCUSSION

There are 355 panel data from purposive sampling which were analyzed in this study. Based on **Table 1**, it is known that on average, the value of the earnings quality of the unit of analysis is 0.21 and this is quite low compared to the highest value of 2.05. The unit of analysis also has the largest average share of only 53.3 percent, high institutional stock of 74.7 percent, relatively high foreign stock 54.2 percent, fairly high asset with an average LN of 0.371 and a long enough industry experience of 43 years. Statistically, all mean variable values are above the standard deviation value, which means the research panel data is good.

Table 1. Descriptive statistic

Var.	PAiT	CON	INS	FOR	SIZE	AGE
MMin	0.000	0.093	0.224	0.049	0.439	18
MMax	2.050	0.996	0.997	0.997	0.212	103
MMean	0.212	0.533	0.747	0.542	0.371	43
SSTD	0.179	0.242	0.183	0.264	0.622	17

Note: PAiT = Earnings Quality, CON = Concentrated Ownership, INS = Institutional Ownership, FOR = Foreign Ownership, FSIZE = Company Size, FAGE = Company Age

Then a model suitability test was carried out to determine the best model, in the Chow test it was found that Fixed Effect Model was better than Common Effect Model, whereas in the LM test it was found that Random Effect Model was better than Common Effect Model, and in the Hausman test it was found that Fixed Effect Model was better than Random Effect Model, and the result is Fixed Effect Model (FEM) is the best model in this study. Using the Ordinary Least Square (OLS) approach in FEM, the data passes the multicollinearity test, while Robustness is used in heteroscedasticity. After selecting the best model and classical assumptions, then a regression test was carried out.

In **Table 2** it is known that the F-table value is 0.0009 which explains that this research model is fit or feasible. The R-Square value of 0.0231 explains that the variables of concentrated ownership, institutional ownership, and foreign ownership can explain 2.31 percent of earnings quality and the remaining 97.69 percent is explained by other variables outside of this study.

Table 2. Main hypothesis test

PAiT = $\beta_0 + \beta_1\text{CON} + \beta_2\text{INS} + \beta_3\text{FOR} + \beta_4\text{FSIZE} + \beta_5\text{FAGE} + \epsilon$					
Var.	Coef.	t-stat		Sig.	Result
CON -> PAiT	0.0295	0.17	0.868		Rejected
INS -> PAiT	-0.7735	-3.94	0.000	***	Accepted
FOR -> PAiT	0.3115	2.30	0.022	**	Accepted
FSIZE -> PAiT	-0.0246	-0.56	0.579		
FAGE -> PAiT	0.0101	2.03	0.043	**	
N	335				
F	0.0009***				
R-Square	0.0231				

PAiT = Earnings Quality, CON = Concentrated Ownership, INS = Institutional Ownership, FOR = Foreign Ownership, FSIZE = Company Size, FAGE = Company Age

Note : * Significant 10%, ** Significant 5%, *** Significant 1%

3.1. Concentrated Ownership on Earnings Quality

Agency theory explain that there is a contract between the principal (capital owner) and the agent (management) in capital management (Jensen and Meckling, 1976), where the principal has a specific purpose in providing capital to the agent in the form of profit while the agent has a specific purpose in managing capital. The benefits provided are in the form of benefits that can be used both personally and for the sustainability of the organization.

While stakeholder theory states that companies operate not only for their own interests but must provide benefits to stakeholders (Freeman, 1984), especially shareholders and creditors as parties whose assets are managed by the company, and of course other stakeholders such as the government and society. So management has the responsibility in making company policies so that they are oriented towards the goals of shareholders and on the side of shareholders, based on the assets owned and managed by the company, shareholders have the authority or can be said to be "power" in supervising every policy taken by management and impact on earnings quality (Alzoubi, 2016). Moreover, the largest shareholder, the portion of shares owned is in line with the amount of power possessed in supervision and special considerations in every policy taken by management. The background or position of shareholders ultimately has an impact on management decisions in management decisions. Some directors are more efficient in improving earnings quality in a healthy investor protection environment (Alhadi *et al.*, 2021).

According to agency theory, the company's ownership structure has a function in monitoring and controlling company policies, especially financial information. Traditionally, the theory states that concentrated ownership should be able to reduce agency problems because the largest shareholder has high authority in the company. Based on the agency theory, this study predicts that ownership concentration has a positive effect on earnings quality. Concentrated ownership can reduce agency costs because of the supervisory authority of the largest shareholder and information asymmetry tends to be low (Al-Jaifi, 2017).

Large shareholders are suspected of having high authority so that management always considers every direction or opinion from the owner and in the end management does not dare to take policies that can reduce the quality of earnings in financial statements (Krismiaji *et al.*, 2019). When highly concentrated ownership has the same interests as the company, the relationship turns positive and the alignment effect dominates, resulting in good financial statement quality (Arthur *et al.*, 2019). First hypothesis this study is concentrated ownership has an influence on earnings quality.

The results of hypothesis testing 1 based on **Table 2** show a sig value of 0.868, which means that concentrated ownership has no significant effect on earnings quality, so H1 is rejected.

This can be interpreted that the power possessed by the majority shareholder does not affect managers in making policies for preparing financial statements which have an impact on the level of earnings quality. This shows that the information asymmetry occurs quite high between the agent and the big principle as is feared in agency theory (Jensen and Meckling, 1976). Detailed information about the company owned by management as an agent is not in line with the information obtained or owned by the majority shareholder, it has a positive or negative impact, depending on the objectives of management in the company's operations. Positively, management is more flexible in making policy because it is not pressured by the majority shareholder, but on the other hand it has a negative impact on the majority shareholder if the direction of management's policy has an impact on the company's negative performance which ultimately harms investors, especially the majority shareholder. These results prove the entity theory which views that the entity is a separate thing and is not the same as the party who invests

capital, so that even though the owner of the capital has a majority share, it is not always able to move the entity which is actually operated by the manager.

The absence of the effect of concentrated ownership on earnings quality is in line with literature which finds that companies with a high level of concentrated ownership have different information conveyed so that it interferes with stock market liquidity (Al-Jaifi, 2017), this indicates an unfavorable effect of concentrated ownership on quality information. These results are also in line with other which examined non-financial companies listed on the Indonesia Stock Exchange in 2012-2013 (Perwitasari, 2014), the large number of shares owned by the largest owners in the company was not able to control management in the process of preparing financial statements, both in earnings management practices or improve earnings quality. Similar results were found in the other study which analyzed all companies on the Indonesia Stock Exchange in the 2015-2019 observation year, the largest shareholder did not have a significant influence in controlling the management and reporting of the company's internal data because not many investors have experience in the capital market, so that its existence is not significant in influencing management in improving earnings quality or minimizing earnings management practices in the company (Karina, 2021).

3.2. Institutional Ownership on Earnings Quality

Monitoring by institutional ownership can be an important governance mechanism (Velury and Jenkins, 2006). This is because institutional shareholders have quite good experience from issuers in managing the company, so high supervision by institutional owners can encourage management to improve the quality of financial information (Diab et al., 2023).

With experience in managing their own institutions, institutional investors have the capability, prospects, and resources to oversee management and ensure timely and quality financial reporting. Therefore, supervision from institutional owners reduces management's ability to manipulate earnings opportunistically (Reyna, 2018; Zhong et al., 2017) and improve earnings quality (Al-Duais et al., 2022; Omran and Tahat, 2020). On the other hand, as in the stakeholder theory, every management policy must consider stakeholders including institutional owners, while the majority of institutions are profit oriented which may have an impact on the low earnings quality in financial statements prepared by management. The second hypothesis of this study is institutional ownership has an influence on earnings quality.

Based on **Table 2**, the results of hypothesis testing 2 show a sig value of 0.000 which means that institutional ownership has a significant influence on earnings quality, so H2 is accepted.

With a negative coefficient value indicates that institutional ownership has a negative effect on earnings quality. These results explain that the higher the company is owned by the institution, the management is encouraged to take policies that have an impact on the low level of earnings quality. As stakeholder theory (Freeman, 1984) explains that the company's policies are taken by the company not only for its own interests but also for other stakeholders, in this case especially shareholders. However, because institutional shareholders are profit-oriented parties, the encouragement to management to polish the financial statements to look beautiful is done so that the public believes and is interested in joining the company's investment.

Institutional owners, as in the theory of business sustainability, certainly have a vision and mission to extend their business ventures, either by themselves or in the form of investments. The vision and mission encourages owners to influence management in the company's policies, one of which is the policy in preparing financial statements that have an impact on the low level of earnings quality. Including tax management with the recognition of time differences that have an impact on the value of deferred tax expense and company profits.

The results of this study are in line with literature who found that institutional ownership weakens earnings quality (Tee and Rasiah, 2020), as well as other who found a positive relationship between institutional ownership and income smoothing which is an indicator of the low quality of corporate earnings. The same thing was found in other which examined non-financial entities on the Indonesia Stock Exchange in the 2015-2017 observation year with the result that the higher the institutional ownership, the greater the opportunity for the company to practice earnings management, thereby reducing the level of earnings quality (Perdana, 2019).

Even so, a literature explains that institutional owners who encourage earnings management are short-term institutional owners (Koh, 2007), while long-term institutional owners tend to encourage management to improve earnings quality. Thus, it is assumed that the institutional owner in the unit of analysis is the short-term owner so that the level of ownership weakens the issuer's level of earnings quality. Furthermore, institutional investors reduce their shareholding in firms with higher earnings quality, explaining the negative impact of institutional ownership on earnings quality (Chada and Varadharajan, 2023).

3.3. Foreign Ownership on Earnings Quality

In global business strategy, some of the main challenging questions are how foreign owners control the management of companies located in different countries (Boubakri *et al.*, 2013). This is mainly related to the different economic conditions in each country, both the owner country and the issuer country, which in the end the power possessed by foreign owners can have a macroeconomic impact on a country. In addition, foreign investors may be able to become stricter supervisors on every company management policy, especially tax policies that have an impact on the company's tax burden which will flow to the country where the company is located and not to the country where the owner is domiciled (Alkurdi and Mardini, 2020; Shi *et al.*, 2020; Yulistia *et al.*, 2020).

Supervision from foreign owners is thought to be stronger in influencing management policies to improve earnings quality which is important information in global investment (Al-Duais *et al.*, 2022; Lee, 2022). The third hypothesis of this study is foreign ownership has an influence on earnings quality.

The results of hypothesis testing 3 in **Table 2** show a sig value of 0.022, meaning that foreign ownership has a significant influence on earnings quality, so H3 is accepted.

With a positive coefficient value indicates that foreign ownership has a positive influence on earnings quality. These results explain that the higher the company is owned by foreigners, the management is encouraged to increase the value of earnings quality from the financial information submitted. In this case, management makes policies not only for internal interests, but also external parties as in stakeholder theory (Freeman, 1984). The purpose of foreign investors in investing in Indonesia is of course to get maximum profit for the investor personally or for the organization as well as for his country from the source of income tax on the investment profits obtained. The high level of supervision from both Procedure Standard and company operational practices is suspected to be the reason for the high level of profit quality of foreign-owned entities.

The results of this study are in line with the literature which explains that foreign investors become stricter supervisors on every company management policy, especially tax policies that have an impact on the company's tax burden which will flow to the country where the company is located and not to the country where the owner is located or domiciled (Alkurdi and Mardini, 2020; Shi *et al.*, 2020; Yulistia *et al.*, 2020). Supervision from foreign owners is thought to be

stronger in influencing management policies to improve earnings quality which is important information in global investment (Al-Duais et al., 2022; Lee, 2022).

Based on the three study results found, the problem of low earnings quality published in the financial statements is in fact a push from the investors themselves, although not all of them. The type of foreign investors is in fact stronger in encouraging management to improve the earnings quality in the financial statements, on the other hand, institutional investors tend to reduce the level of earnings quality. Of concern is the absence of the effect of concentrated ownership on earnings quality, which reflects the high asymmetry of information between management and investors in the unit of analysis so that the majority owner cannot control management to prepare better, higher quality financial reports and produce financial information that can be used by various parties.

These results can not only be used by investors in making investment policies but can also be a concern for the government in making policies related to the preparation of financial statements, especially companies listed on the stock market to improve the quality of financial statements.

3.4. Sensitivity Test

Sensitivity test was carried out in analyzing the effect of tax on earnings quality indicators which initially used Performance Adjusted Decisionary Accrual (PAccr) to Performance Adjusted Accrual include Tax (PAiT).

The sensitivity test described in **Table 3** explains that tax management with the recognition of time differences in the output of deferred income tax (DIT) has an influence in measuring earnings quality. The R-Square value of model 1 with the use of PAiT as an indicator of higher earnings quality is explained by concentrated ownership, institutional ownership, foreign ownership, company size and company age compared to the R-Square value in model 2 with the use of PAccr as an indicator of earnings quality.

Table 3. Sensitivity test

Var.	Y=PAiT			Y=Paccr		
	Koef.	Sig		Koef.	Sig	
CON	0.02	0.86		0.04	0.81	
INS	-0.77	0.00	***	-0.85	0.00	***
FOR	0.31	0.02	**	0.34	0.01	**
FSIZE	-0.02	0.57		-0.02	0.54	
FAGE	0.01	0.04	**	0.00	0.05	*
N	355			355		
R-Square	0.023			0.015		
Prob F	0.000	***		0.000	***	

PAiT = Kualitas Laba, CON = Kepemilikan Terkonsentrasi, INS = Institutional Ownership, FOR = Foreign Ownership, FSIZE = Ukuran Perusahaan, FAGE = Usia Perusahaan
Ket: * Signifikan 10%, ** Signifikan 5%, *** Signifikan 1%

These results are in accordance with the literature which explain that the time difference policy taken by management with deferred tax output is also used by management in earnings manipulation which reduces the level of earnings quality from financial statements prepared by the entity (Kasipillai and Mahenthiran, 2013; Tarmidi et al., 2022).

4. CONCLUSION

The Based on the results discussed, this study found concentrated ownership has no effect on earnings quality, institutional ownership has a negative effect on earnings quality, while foreign ownership has a positive effect on earnings quality.

These results contribute to investors who still use financial information and analyze earnings quality to be able to use the ownership structure, especially the level of foreign and institutional ownership.

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