The Effect of Profitability, Firm Size, and Investment Opportunity Set (IOS) on the Earnings Quality

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Abstract

The existence of profit management practices done by some large categorized companies tend to have a high profit but not yet be assured the resulting earning has good quality or not. The research was conducted to find empirical evidence of the influence of profitability, firm size and Investment Opportunity Set (IOS) on the quality of profit at the manufacturing companies of the food and beverage sub-sector listed at IDX from 2013 to 2018. In this study were secondary data originating from the annual report of the company's sub-sector and beverage-listed manufacturing companies in the year 2013-2018. Samples used as many as 11 companies. Data is processed with Eviews version 10 software. The results showed that profitability has a probability value of $0.5209 > 0.05$ with a value of t-count $-0.646268 <$ t-table 1.89458 and firm size has a probability value of $0.6905 > 0.05$ with $-0.400462 < 1.89458$, so that it can damage profitability and company size has no effect on earning quality. Meanwhile, the Investment Opportunity Set (IOS) has a probability value of $0.0037 < 0.05$ with a value of t - count $3.044327 >$ t - tab el 1.89458, which means that IOS has a positive and significant effect on earning quality.

Keywords: Profitability, Firm Size, Investment Opportunity Set (IOS), Earnings Quality.

1. Introduction

One of the parameters for measuring company performance can be seen from the information about its profits. Income generated by the company to be seen and analyzed in again if the income had earnings quality is good or not, because it can affect each making economic decisions by management and investors. Profits that do not show actual information about management performance can make it difficult for users of financial statements. Profits that have good quality are profits that can be used by users of financial statements in making the best decisions and meet the qualitative criteria of financial statements, namely relevance and reliability (Warianto, 2014). Profits cannot be said to be of quality if managers tend to practice earnings management which results in profits that cannot be said to have good quality, as was the case with the phenomenon that occurred in the Japanese electronics giant Toshiba in 2015.

According to Lestari (2017) states that , there are 21 cases of bookkeeping per March 31, 2014 primarily related to the construction works, calculation and bookkeeping Toshiba has been manipulated so as corporate profits increase. A miscalculation made by Toshiba was officially announced at 54.8 billion yen. (www.tribunnews.com). The results, which have been investigated by independent accountants, have made a profit *mark-up* of US $ 12 billion dollars over several years. The placement of large losses by Toshiba is possible in the amount of 10 billion yen or around Rp1, 17 trillion in its 2014/2015 financial report (www.tribunnews.com). From many cases of *fraud* in financial reports, especially the existence of earnings management practices that will affect the quality of earnings itself, 40.3% of the *middle managerial* level did it the most. It can be seen from the following picture.
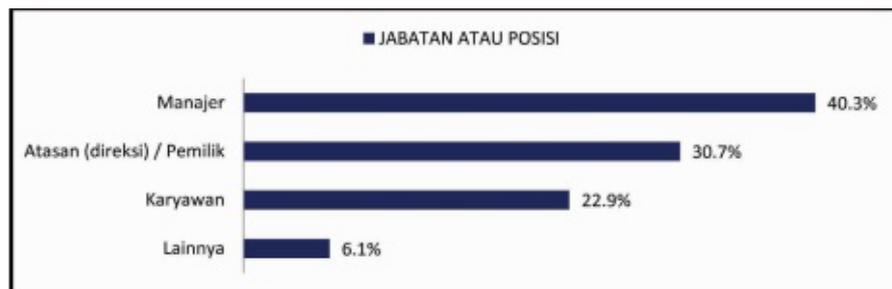

Figure 1. Position or Position of *Fraud* Perpetrators
Source: acfe-indonesia.or.id

From this phenomenon, it can be said that the existence of management actions that report earnings that do not reflect the actual condition of the company results in doubtful quality of the resulting profits (Wati and Putra, 2017). The factors that can affect the quality of earnings, one of which is looking at the profitability ratio. Profitability is the company's ability to generate profits. Profitability itself is the ability of a company to generate a profit or profit. High profitability reflects the company's ability to generate high returns for shareholders (Dewi and Wirajaya, 2013). In the case of earnings management, it can be seen that companies that generate high profits do not necessarily have good quality because these high profits are obtained from manipulation of their earnings information. Profit information itself can be seen from the level of profitability. The results of Warrad's research (2017) state that profitability has a positive and significant effect on earnings quality, while Laoly and Herawati (2019) state that profitability has a negative and significant effect on earnings quality. But it is different from the research results of Ma'ruf and Sayekti (2018), Hakim and Abbas (2019) and Tao (2019) which state that *Return on Assets* (ROA) which is proxied for profitability does not have a significant effect on earnings quality.

Earnings quality can also be influenced by firm size. The greater the size of a company, the higher the level of *going concern of the* company in improving financial performance, which causes the company to not tend to practice earnings management (Ananda & Ningsih, 2016). But, seeing the case of Bank Lippo which has high total assets indicates that large-scale companies with total assets of more than 10 billion are still practicing earnings management. So that the quality of the profit is still in doubt. Research conducted by Ananda and Ningsih (2016) as well as Ali *et al.,* (2015) show that company size has a positive and significant effect on earnings quality. Meanwhile, Warianto and Rusiti's research (2016) states that company size has a negative effect on earnings quality. Different research results were also shown by Wati and Putra (2017), Budiani (2019) and Hutagalung *et. al* (2018) which states that firm size has no significant effect on earnings quality. Another factor that can affect earnings quality is the *Investment Opportunity Set* (IOS). According to Narita and Taqwa (2020) mentions that the d natural implementation of the principle of *going concern,* the funds required for the company so that the company's growth can be increased. *The*

Investment Opportunity Set (IOS) is a firm value whose amount depends on the *expenditure* set by management in the future, which is currently investment options that are expected to produce large *returns* (Narita and Taqwa, 2020).

Companies that have a high *Investement Opportunity Set* (IOS) have high growth opportunities which will affect the quality of their earnings information (Oktarya *et al.,* 2014). If a company has a high IOS, management will provide this information to financial statement users to attract investors to invest in the company. The research results of Warianto and Rusiti (2016), Tao (2019), and Hakim and Abbas (2019) state that IOS has a positive and significant effect on earnings quality. In contrast to the research results from Wulandari and Aris (2018), Hutagalung *et. al* (2018) and Budiani (2019) which state that the *Investment Opportunities Set* (IOS) has no significant effect on earnings quality. The research object to be used is a food and beverage sub-sector manufacturing company listed on the Indonesia Stock Exchange (IDX) from 2013 to 2018. According to Hakim and Abbas's research (2019), food and beverage companies are one of the industrial sectors that have opportunities. to grow and develop so that company managers will compete to pursue investors to invest their funds in the food and beverage company. Based on the phenomena and *research gap* in previous studies, it can be said that this study was conducted to test and analyze the variables that affect earnings quality based on the findings of previous researchers regarding profitability, company size and the *Investment Opportunity Set* (IOS) which is important information for investors. in decision making.

2. Literature Review

Agency Theory

According to John Wiley and Sons (2011: 9) in their book, Jensen and Meckling say that agency theory is the relationship between shareholders as principal and management as agents. Management is given responsibility by the shareholders or the *principal* and works in the interests of the shareholders or the principal. Because they are elected, the management must be responsible for all its work to the shareholders or the principal. On this theory in assuming if everyone simply be motivated by self-interest that would give rise to a conflict of interest between principal and agent. With the agent's interest, it will affect the quality of their financial reports, especially their earnings. Quality earnings are profits that can show the continuation of profits in the future (Pangestika, 2019).

Profitability

According to Keiso, Weygant, and Warfield (2014: 215), the profitability ratio is a ratio to measure the success or operations of a company for a certain period of time. The formula used to calculate the level of profitability is as follows according to Ka s Mir (2016: 199):

$$\text{ROA} = \frac{\text{Profit After Tax}}{\text{Total Assets}} \times 100\%$$

Firm Size

The size of the firm is the large or small scale of a company which is determined by predetermined boundaries (Aryengki, 2016). The formula for determining the size of the firm is as follows:

$$\text{Firm Size} = \text{Ln Total Assets}$$

Investment Opportunity Set (IOS)

Outside parties cannot observe investment decisions directly. Myers (1984) in Fahlevi (2016) who introduced the Investment Opportunity Set (IOS) for the first time, namely the Investment Opportunity Set (IOS), provides a broader indication of the value of a company that depends on the company's future expenditure. The formula for measuring the *Investment Opportunity Set* (IOS) is as follows:

$$\text{IOS} = \frac{\underline{\text{Number of shares outstanding x } \textit{Closing Price}}}{\textbf{Total Equity}}$$

Profit Quality

According to Dechows et. al., (2010) stated that the quality of earnings is a sign with high quality that will provide more information about the company's financial performance that is relevant to specific decisions made by certain decision makers. Measurement of earnings quality proxied by Discretionary Accruals (DA) with the Modified Jones model is as follows according to Suli Styanto (2014: 219).

Hypothesis Development

Effect of profitability on earnings quality

Profitability is a factor that must receive important attention because in order to continue its life, a company must be in a profitable state (Azlina and Reyhan, 2014). The greater the ROA of a company, the greater the level of profit achieved by the company. So it can be said that the company has good earnings quality (Ginting, 2017). Based on this description, the hypotheses developed are:
H1: Profitability has a positive and significant effect on earnings quality.

The influence of firm size on earnings quality

Good or bad company performance can be determined from the size of the company. Investors usually prefer trust in companies on a large scale. This is because companies that have a large scale are considered capable of improving their company's performance by seeking to improve the quality of their earnings (Warianto and Rusiti, 2014). Large-scale companies have a high rate of turnover of capital so that the quality of their profits will be even better. Based on this description, the hypotheses developed are:
H2: Company size has a positive and significant effect on earnings quality

***Investment Opportunity Set* (IOS) on earnings quality**

Investment Opportunity *Set* (IOS), which is a choice of future investment opportunities that can affect the growth of company assets. The company's profit in the future will continue to increase if there is a chance the company to grow through investment opportunities, so that the market will respond much higher to increase the return on the company. The higher the *Investment Opportunity Set* (IOS) which is owned by the company will be better quality of earnings generated (Widmasari *et. Al.* 2019). Based on this description, the hypotheses developed are:
H3: *Investment Opportunity Set* (IOS) has a positive and significant effect on earnings quality.

Framework

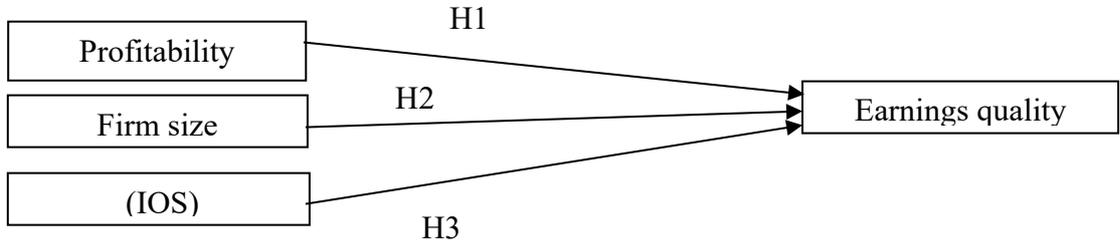The theoretical framework of this research is as follows:

Figure 2. Framework

3. Methodology

The population taken in this study is annual report data from food and beverage sub-sector manufacturing companies listed on the Indonesia Stock Exchange from 2013 to 2018. The method used in sampling is purposive sampling.

Table 1. Sampling

Criteria	Total
Annual report of food and beverage sub-sector manufacturing companies listed on the IDX	31
The annual report of the food and beverage sub-sector manufacturing companies *listed* on the IDX above in 2013	(9)
Annual reports of companies *listed* on the IDX are not consecutive years 2013-2018	(0)
Completely incomplete company annual reports are based on variables	(6)
Annual reports of companies that have experienced losses during the research period	(5)
Total Sample Number	**11**
Period 2013 - 2018	**6**
Sample Units (11 x 6)	**66**

Source: data processed, 2020

In this research, the following equation can be formed:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e_i$$

Information:
Y   : Profit Quality
X_1 : Profitability
X_2 : Firm Size
X_3 : *Investment Opportunity Set* (IOS)
e_i : component *error*

4. Result and Discussion

Table 2. Descriptive Statistics

	Profit Quality	ROA	SIZE	IOS
Mean	0.136305	0.077880	29.01299	2.835543
Median	0.125977	0.074312	28.70204	2.722349
Maximum	0.372461	0.167443	32.20096	7.301770
Minimum	0.008800	0.010369	26.43366	0.256446
Std. Dev.	0.084161	0.039686	1.482256	1.804152
Skewness	0.597508	0.265618	0.575353	0.466283
Kurtosis	2.970302	2.365183	2.790104	2.304595
Jarque-Bera	3.929603	1.884314	3.762500	3.721485
Probability	0.140184	0.389786	0.152399	0.155557
Sum	8,996142	5.140064	1914,857	187,1458
Sum Sq. Dev.	0.460397	0.102372	142.8103	211.5726
Observations	66	66	66	66

Source: Processed Data, 2020

Based on table 2 the minimum value of profitability (ROA) as an independent variable (X1) is 0.010369 and the maximum value is 0.167443 with an average value of 0.077880, and a standard deviation of 0.039686. The average value of profitability (ROA) of 7.79% indicates that, on average, the sample companies can generate net income from their total assets of 7.79%. The minimum value of Firm Size (*SIZE)* as an independent variable (X2) is 26.43366, while the maximum value is 32.20096, with an average value of 29.01299 and a standard deviation value of 1.482256. This result is the total assets of the company that have been logged. The minimum value of the *Investment Opportunity Set* (IOS) as an independent variable (X3) is 0.256446, while the maximum value is 7.301770, with an average value of 2.835543 and a standard deviation value of 1.804152. This shows that the average *investment opportunity set is* 283.55% of the companies used as the research sample. Earnings quality as the dependent variable (Y) has a minimum value of 0.008800, while the maximum value is 0.372461, the average value is 0.136305 and the standard deviation value is 0.084161. The average value of 13.63% indicates that the average earnings quality of the sample companies studied is 13.63% of the total earnings quality. The lowest minimum value of all variables of 0.008800 lies in the dependent variable, namely earnings quality, while the highest minimum value of all variables is 26.43366 which is in the firm size variable, the highest mean value is 29.01299 which lies in the firm size variable while the lowest average value lies in the profitability variable of 0.077880. The largest standard deviation of 1.804152 lies in the *investment opportunity set* variable, while the smallest standard deviation of 0.039686 lies in the profitability variable.

Table 3. Results of the Best Model Selection Test (Chow Test)

Redundant Fixed Effects Tests Equation: UJICHOW Fixed effects cross-section test			
Effects Test	Statistics	df	Prob.
Cross-section F	31.163503	(10.52)	0.0000
Chi-square cross-section	128.363860	10	0.0000

Source: Eviews 10, Data processed, 2020

Based on table 3 above, it can be seen that the probability of *cross-section* F is 0.0000, which means <0:05, so we can conclude that H0 is rejected and accepted Ha which means *Fixed Effect Model* (FEM) is more appropriate than the *Common Effect Model* (CEM).

Table 4. Results of the Best Model Selection Test (Hausman Test)

Correlated Random Effects - Hausman Test Equation: UJIHAUSMAN Cross-section random effects test			
Test Summary	Chi-Sq. Statistics	Chi-Sq. df	Prob.
Random cross-section	10.842569	3	0.0126

Source: Eviews 10, Data processed, 2020

Based on table 4 above, it can be seen that the probability value of *random cross-section* is 0.0126 with a value of <0.05, so it can be concluded that H0 is accepted and Ha is rejected, which means that the best model to use is the *Fixed Effect Model* (FEM). From the two model selection tests, it can be concluded that in this study the *Fixed Effect* (FE) model is better than the *Common Effect* (CE) or *Random Effect* (RE) model.

Table 5. Results of Testing the *Fixed Effect Model* Research *Model*

Dependent Variable: Earnings Quality
Method: Least Squares Panel
Date: 07/11/20 Time: 19:41
Sample: 2013 2018
Periods included: 6
Cross-sections included: 11
Total panel (balanced) observations: 66

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.298072	0.462735	0.644153	0.5223
ROA	-0.126980	0.196482	-0.646268	0.5209
SIZE	-0.006329	0.015805	-0.400462	0.6905
IOS	0.011200	0.003679	3.044327	0.0037

R-squared	0.913892	Mean dependent var		0.136305
Adjusted R-squared	0.892365	SD dependent var		0.084161
SE of regression	0.027611	Akaike info criterion		-4.155352
Sum squared resid	0.039644	Schwarz criterion		-3.690880
Log likelihood	151.1266	Hannan-Quinn criter.		-3.971817
F-statistic	42.45316	Durbin-Watson stat		1.939825
Prob (F-statistic)	0.000000			

Source: Eviews 10, Data processed, 2020

Discussion

Profitability on earnings quality

The results of hypothesis testing in table 5 show that profitability (ROA) has a probability value of 0.5209> 0.05 and the comparison between t_{count} and t_{table} is - 0.646268 <1.89458 with a *coefficient* of - 0.126980 which indicates that the independent variable profitability has no significant effect on earnings quality. The negative coefficient value illustrates the negative correlation between profitability and earnings quality. The results of this study indicate that there is no significant effect between profitability on earnings quality, which means that the higher or lower the profitability, which is proxied by the ROA produced by a company, will not affect the quality of the resulting earnings. Because companies with high profits cannot be ascertained that these profits are of quality. The results of this study do not support the theory put forward by Ginting (2017) which explains that the greater the ROA of a company, the greater the level of profit achieved by the company, and it can be said that the company has good earnings quality, which means that the profitability hypothesis has a positive and significant effect. on earnings quality is unacceptable. High profits can be generated from the manipulation of earnings to benefit the company in attracting investors as dijela s right d nature of agency theory which states that often everyone is motivated for the benefit of himself that cause actions caused earnings management in a company. The results of this study are in line with the results of research conducted by Ma'ruf and Sayekti (2018), Hakim and

Abbas (2019) and Tao (2019) which state that *Return on Assets* (ROA) which is proxied for profitability does not have a significant effect on earnings quality.

Firm size on earnings quality

The results of hypothesis testing in table 5 show that company size (SIZE) has a probability value of 0.6905> 0.05 and the comparison between t_{count} and t_{table} is - 0.400462 <1.89458 with a *coefficient* value of - 0.006329 which indicates that the independent variable company size has no significant effect on earnings quality. The coefficient value is negative, which means it describes a negative correlation between company size and earnings quality. The results of this study support the theory put forward by Santana and Wirakusuma (2016) which states that the size of the company will encourage earning management practices. Small companies will increase the amount of their profits with the aim of attracting investors in investment so that the company will continue to grow, while companies that are categorized as large scale carry out earnings management practices to avoid uncertain profits, equitable profits will prevent the company from experiencing a decline in share prices, trust from the investor's side. So it can be concluded that the quality of earnings owned by large companies and small companies is not determined by the factor of how big the company is. Firm size is only used to classify large, medium, and small companies, which means that the hypothesis of firm size has a positive and significant effect on earnings quality which is unacceptable. The results of this study are in line with research conducted by Wati and Putra (2017), Budiani (2019) and Hutagalung *et. al* (2018) which states that company size has no effect on earnings quality.

***Investment Opportunity Set* (IOS) on earnings quality**

The results of hypothesis testing in table 5 show that the *investment opportunity set* (IOS) has a probability value of 0.0037 <0.05 and the comparison between t_{count} and t_{table} is 3.044327> 1.89458 with a *coefficient* value of 0.011200 which indicates that the *investment opportunity set* variable has a positive and significant effect. on earnings quality. The coefficient value is positive, which means it describes a positive correlation between the *investment opportunity set* and the quality of earnings. The results of this study indicate that there is a positive and significant influence between the *investment opportunity set* variable on earnings quality. This means that the IOS is used as the basis for investors to invest their funds in a company. The company's profit in the future will continue to increase if there is a chance the company to grow through investment opportunities, so that the market will respond much higher to increase the return on the company. The higher the *Investment Opportunity Set* (IOS) which is owned by the company will be better quality earnings generated. So it can be interpreted that the *Investment Opportunity Set* (IOS) hypothesis has a positive and significant effect on earnings quality. The results of this study are in line with the results of research conducted by Warianto and Rusiti (2016), Tao (2019) and Hakim and Abbas (2019) which state that IOS has a positive and significant effect on earnings quality. The *Adjusted R square value is* 0.892365, which means that the quality of earnings can be explained by profitability, company size, and the *investment opportunity set* (IOS) of 89.23% and the remaining 10.77% is caused by other variables that are not used in the model.

5. Conclusion

Based on the results of testing and discussion of the data, the author can draw conclusions from the research results, namely that profitability as measured using *Return on Assets* or ROA has no effect on Earning Quality. Firm Size has no effect on Earning Quality. Meanwhile, the *Investment Opportunity Set* (IOS) variable has a positive and significant effect on earnings quality. This research

has been carried out and pursued in accordance with scientific procedures, but still has limitations, namely: The independent variables used in this study only consist of profitability, company size, and *investment opportunity set* (IOS) while there are many other variables that can be used. effect on earnings quality and has not been included in the study. The sample used in this study is only data from annual reports on food and beverage sub-sector manufacturing companies listed on the IDX so that it does not describe the same effect on other sub-sectors of manufacturing companies and on other companies so that it is expected for further studies. using a sample of companies in different types of subsectors or different types of companies other than manufacturing companies. The time span of the research carried out was still relatively short, namely for six years, so it is hoped that in future studies the observational research period will be longer so that the results obtained will be more precise and accurate. For companies, this research is expected to become a means for consideration in the future in providing information to the public with virtually no action *fraud* so that the profits generated can be assured of good quality to attract more investors to invest in the company.

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