

# Analysis of Factors that Influence Profit Quality in Manufacturing Companies

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## Abstract

Earnings quality is a crucial metric for evaluating corporate performance and comprehending the long-term financial viability. This research examines several factors' impact on earnings quality by analyzing data from manufacturing businesses listed on the IDX. The key determinants in this study are the extent to which profit is sustained over time, the company's scale, and its liquidity level. The data was extracted from financial reports retrieved from the website [www.idx.com](http://www.idx.com). This research falls under the category of quantitative analysis. The purposive sampling method acquired the research sample, which involves selecting models based on preset criteria. Using the purposive sampling strategy, a total of 41 firms were obtained. Data analysis techniques include descriptive statistical tests, panel data model selection tests, f-tests, t-tests, and coefficient of determination tests. The hypothesis testing in this research uses Eviews version 10.0 with panel data. The research findings indicate that leverage substantially impacts profit quality, whereas earnings persistence and business size do not significantly influence earnings quality in manufacturing enterprises.

**Keywords:** Profit Quality, Profit Persistence, Company Size, Liquidity, Manufacturing Companies

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## Introduction

The primary aim of a corporation is to achieve profitability to assure its sustainability and foster expansion, particularly in the context of competitive market dynamics. A company's viability and competitiveness can be determined through the examination and analysis of its financial report. Investors are more inclined to spend money on a specific company if it demonstrates robust success. Nevertheless, if a company cannot properly engage in competition, its overall performance may experience a decline, leading to financial difficulties and maybe even bankruptcy. Financial distress refers to the situation in which a firm faces challenges in maintaining an adequate level of liquidity and encounters a decrease in its ability to fulfill its obligations to creditors (Febriyan, 2018). A reduction in product quality, a delay in delivery, and

a delay in paying off bank debts are the hallmarks of this condition. Hariyanto (2019) emphasizes the need for organizations to swiftly recognize and acknowledge financial difficulties and take proper actions to mitigate them. By implementing this approach, companies can reduce the potential for more detrimental outcomes, such as financial insolvency.

Financial reports are commonly generated to convey information about a firm's financial condition at a particular moment to individuals or groups with a vested interest in the organization (Amaliah, 2013). According to Murni (2001), those who use financial reports may utilize this information as a basis for determining various approaches to allocate the restricted resources of a firm. According to Yocelyn and Christiawan (2012), financial reports can serve as a fundamental basis for making investment and credit choices, hence obviating the necessity for several pieces within a given accounting period. The primary purpose of financial reports is to assess the potential cash flow prospects. According to Maruta (2017), financial statements provide data that can be used to project future cash flows. Financial reports are valuable for investors to make well-informed decisions to optimize their investment capital (Dimara & Hadiprajitno, 2017). Lenders employ financial analytics to ascertain loan conditions and interest rates (Husni, 2013). According to Pratiwi et al. (2014), financial reports play a crucial role in facilitating government oversight and management of corporate operations, as well as in establishing tax legislation and collecting data for national income statistics. Profit is a prominent element inside financial reports that garners substantial focus and scrutiny. According to Hasti and Herawaty (2017), it functions as a metric for evaluating the operational efficiency of a corporation. Investors depend on earnings information to assess the integrity of results and make well-informed judgments. The issue of earnings quality is a subject of interest for various stakeholders, including investors, accounting policymakers, and government officials (Agustina & Mulyani, 2017).

The concept of earnings quality relates to the importance of earnings in evaluating corporate performance. The two main factors that affect the quality of earnings are the business environment in which a company operates and the accounting rules that the company chooses and uses (Wati & Putra, 2017). The process of quantifying and acknowledging earnings requires the assessment and analysis of commercial transactions and occurrences (Kurniawansyah, 2018). Pursuing profit objectives may result in managers or organizations neglecting solid business practices. As a result, the quality of results and financial reporting has remained the same. According to Andalawestyas and Ariyati (2019), profit engineering involves the motivation of individual managers and the alignment with the company's objectives. The degree of earnings persistence has an impact on the quality of earnings. Profit persistence is a concept that pertains to a firm's ability to maintain its current level of profitability over time (Khasanah, 2019). There exists a positive correlation between greater earnings persistence and higher earnings quality. This suggests that the company's profits exhibit a high level of quality. Therefore, it can be deduced that the enduring nature of profits has a significant and positive influence on the earnings' quality (Rizqi et al., 2020). Profit persistence is a quantitative measure that provides insight into a company's ability to maintain and preserve its earnings over a series of successive years, hence strengthening its overall stability and financial viability (Putri & Fitriasari, 2017). Investors tend to exhibit a proclivity toward demonstrating interest in a company that constantly earns profits. Investors believe that a company indicating consistent profitability can maintain its financial stability (Gusnita & Taqwa, 2019).

A company's scale also influences the quality of its earnings. A corporation's total assets, number of employees, stock market value, sales history, and market capitalization are just a few factors that affect its size. The above criteria are employed to categorize a company as large or small (Nikmah, 2019). In general, large organizations exhibit somewhat lower levels of risk in comparison to small businesses. According to Setiawan's (2017) research, there is a correlation between a company's size and its profitability level. However, Novianti (2012) discovered that a corporation's size does not influence the company. Leverage is an additional factor that influences the quality of earnings. According to Hidayat and Galib (2019), "leverage" is when a company uses its financial resources and assets that have fixed costs in a planned and strategic way to increase the possible gains for its stockholders. The debt ratio is employed as a metric to quantify the level of leverage. The debt ratio is a metric that measures the proportion of debt that a firm uses to finance its assets (Wulansari, 2013). According to Listyawan's (2017) research, there is a connection between leverage and business profitability. However, according to Irawati's (2012) research, it has been determined that there is no significant influence of leverage on the quality of earnings. Due to the inconsistencies observed in prior research outcomes, it is recommended that additional investigations be undertaken to explore the potential influence of Profit Persistence, company size, and leverage on the profitability of manufacturing firms operating within distinct industrial and consumer goods sectors listed on the Indonesia Stock Exchange (BEI) during the period spanning from 2019 to 2022.

According to the definition provided by Schipper and Vincent (2003), earnings quality pertains to the financial results that offer a reliable assessment of current performance and establish a basis for forecasting future performance. Dechow et al. (2010) present a comprehensive elucidation of three fundamental notions that necessitate comprehension: The quality of earnings depends on incorporating relevant information in the decision-making procedure. Moreover, the evaluation of earnings quality involves the examination of profit metrics presented in the financial statements and the judgment of whether the reported earnings effectively reflect the financial performance of the organization. Moreover, determining profit quality is contingent upon various criteria, including the magnitude of financial achievement, which is a fundamental basis for decision-making. According to Lo (2008), the classification of earnings quality components and their measurement may be organized into four categories. Some of these criteria are the timing of earnings, the quality of the conceptual framework, the relationship between earnings, cash, and accruals, and the decisions made during implementation. Profit persistence, as conceptualized by Penman and Zhang (2002), pertains to revising projected future profits in light of the present changes in earnings. Hanlon (2005) conducted a study that suggests that earnings persistence can be utilized as an indicator of earnings quality due to its ability to predict future outcomes. Financial reports allow consumers to analyze historical, current, and prospective occurrences. Dechow et al. (2010) have shown that a significant body of research has focused on applying earnings in stock valuation when examining the persistence of earnings. The categorization of research on earnings persistence can be attributed to Dechow et al. (2010), who recognized two distinct streams in this study area. The initial stream of thought assumes that earnings with a longer duration will lead to more effective inputs for equity valuation models.

The term "corporation size" pertains to the categorization of a corporation according to its logarithmic magnitude. The total value of its assets measures the size of a firm. Hence, a positive correlation exists between the importance of a firm's assets and its overall size. Hery (2017)

categorizes company size into three broad groups: huge companies, medium firms, and small firms. According to Lestari (2010), there are distinct advantages that large companies have over small companies. Some of these benefits are being able to accurately predict how easy it will be to get money from the capital market, figuring out how much leverage financial contracts might have, and taking advantage of economies of scale and return effects, all of which help big businesses make a lot of money. Law number 20 of 2008 classifies the magnitude of firms into four distinct categories: microenterprises, small companies, medium businesses, and large businesses. Leverage is when a company uses its money and assets strategically to make potential profits bigger for its shareholders while still paying for fixed costs (Oktaviarni et al., 2019). The debt ratio is employed as a metric to quantify the level of leverage. The debt ratio is a metric used to measure the proportion of debt a company holds to finance its assets (Sutama & Lisa, 2018). A substantial amount of debt within a corporation can diminish investors' trust in the company's declared profitability. Dewi & Putra (2017) posit that investors believe that firms prioritize debt repayment to debtholders over dividend distribution. As a result, an increase in firm leverage is associated with a decline in the quality of a company's profitability.

*H<sub>1</sub>*: Earnings Persistence has an influence on earnings quality.

*H<sub>2</sub>*: Company size has an influence on earnings quality.

*H<sub>3</sub>*: Leverage has an influence on earnings quality.

## Research Design and Method

The research employed a quantitative methodology with a causal research design. Causality research examines the impact of independent variables on the dependent variable. The study utilized manufacturing companies from different industrial and consumer goods sectors listed on the Indonesia Stock Exchange from 2019 to 2022. These companies were selected using a purposive sampling method, where specific criteria were used to determine the research subjects. The study population consisted of 83 enterprises, out of which 41 matched the specified requirements. Therefore, a total of 123 observations were collected over three years. This study employs numerous linear regression analyses using the Eviews 10.0 software. The comments include the Likelihood Test, Hausman Test, t-Test, F-test, coefficient of determination test, and linear regression test.

## Results and Discussion

The Likelihood Test is carried out to determine which panel data research model is better to use, between the common effect model or the Fixed Effect Model. The test results are presented in the following table 1.

**Table 1. Likelihood Test Results**

Effects Test	Statistics	df	Prob
Cross-section F	6.342546	(40.77)	0.0000
Chi-Square Cross-section	176.849283	40	0.0000

Source: Data processed, 2021

Based on the results of this table, it can be concluded that the significance value is 0.0000, which is much smaller than the specified significance level, namely  $\alpha$  of 0.05. This indicates that the fixed effect model is a more appropriate choice in the context of this analysis. Thus, there is strong evidence that the variability observed in the data is the result of constant variation between individuals or units of observation, not caused by other factors outside the model. Therefore, using a fixed effect model will produce more consistent and reliable parameter estimates, providing more accurate results in analyzing the impact of the independent variable on the dependent variable.

The Hausman test is carried out to determine which is the best model in panel data research used between the fixed effect model and the random effect model. Test results are presented in the following table 2.

**Table 2. Correlated Random Effects - Hausman Test**

Test Summary	Chi-Sq. Statistics	Chi-Sq. df	Prob.
Random cross-section	3.616979	3	0.3057

Source: Data processed, 2021

The Hausman test results listed in Table 2 show that the resulting probability, namely  $\alpha$  0.3057, is much greater than the previously determined significance level of 0.05. Based on this interpretation, it is concluded that there is not enough strong statistical evidence to reject the null hypothesis ( $H_0$ ). Therefore, the fixed effect model is a more appropriate choice in the context of this analysis. On the other hand, if the resulting probability is less than the specified significance level, namely 0.05, then  $H_0$  will be rejected, so the most appropriate model is the random effect method. Taking these criteria into account, the fixed effects model is considered more accurate because it allows to control for individual characteristics that do not change over time, thereby minimizing unobserved bias and providing more consistent and reliable results in this study.

The multiple linear regression analysis test is to determine whether there is an influence of the independent variable on the dependent variable. The test results are presented in the following table 3.

**Table 3. Multiple Linear Regression Test Results**

Variables	Coefficient	Std. Error	t-Statistics	Prob.
C	43.46844	44.23270	1.538763	4.548781
X1	-0.077112	0.535448	-0.145200	0.8632
X2	-1.380462	1.538763	-0.895258	0.3514
X3	0.013159	1.538763	4.548781	0.0000

Source: Data processed, 2021

Based on table 3 above, a multiple regression equation can be formed which functions to see the influence that each independent variable has on the dependent variable. The following is the multiple linear regression equation formed in this research:

$$Y = 43.46844 - 0.077112X1 - 1.380462X2 + 0.013159X3 + e$$

Model feasibility test (F test). To test the hypothesis, an F statistical test is carried out which aims to show that the independent variable has a simultaneous effect on the dependent variable. The test results are presented in the following table 4.

**Table 4. Model Feasibility Test Results (F Test)**

F-statistic	<b>7.363907</b>
Prob (F-statistic)	<b>0.000141</b>
Dependent Variable: Y	
Method: Panel EGLS (Cross-section random effects)	
Cross-sections included: 41	
Total panel (balanced) observations: 123	

From the test results, it was found that the significance value obtained was 0.000141, indicating that there was a significant influence of the independent variable on the dependent variable in this study. This indicates that the multiple linear regression model used is effectively able to explain and measure the relationship between the independent variable and the dependent variable. These findings confirm that the variables studied together can make an important contribution to the observed variation in the dependent variable. Therefore, the suitability of the multiple linear regression model in the context of this research illustrates the match between the independent and dependent variables, strengthens the validity of the interpretation of the results and provides confidence in the validity of the analysis carried out.

The t test is used to determine whether there is an influence of the independent variable on the dependent variable individually. The test results are presented in the following table 5.

**Table 5. t-test results**

Variables	Coefficient	Std. Error	t-Statistics	Prob.
C	43.46844	44.23270	1.538763	4.548781
X1	-0.077112	0.535448	-0.145200	0.8632
X2	-1.380462	1.538763	-0.895258	0.3514
X3	0.013159	1.538763	4.548781	0.0001

Dependent Variable: Y  
Method: Panel EGLS (Cross-section random effects)

Based on the t test results in Table 5, the significance value for variable X1, which is earnings persistence, is 0.8632, which is much greater than the previously determined significance level, namely 0.05. These results indicate that earnings persistence does not have a significant influence on earnings quality. Meanwhile, for variable X2, namely company size, the significance value is 0.3514, which is also greater than 0.05, indicating that company size does not have a significant influence on earnings quality. However, for variable X3, namely Leverage, the significance value is 0.0001, which is much smaller than 0.05, indicating that Leverage has a significant influence on earnings quality. These findings indicate that in the context of this research, leverage is a factor that plays an important role in influencing the quality of company earnings. The implications of these results highlight the importance of managing leverage effectively to improve earnings quality, while other variables such as earnings persistence and company size do not have a significant impact in influencing earnings quality.

The coefficient of determination test aims to measure the level of influence of the independent variable on the dependent variable. The test results are presented in the following table 6.



**Table 6 Determination Coefficient Test Results**

R-squared	0.155612
Adj R-squared	0.134350

From Table 6, the adjusted R-square value is 0.134350 or equivalent to 13.44%. This indicates that the independent variables included in the regression model are able to explain around 13.44% of the variation that occurs in the dependent variable, namely earnings quality. The remainder, around 86.56% of the variation is influenced by other factors not examined in this study. These results provide a clear understanding that although several factors have been included in the model to explain variations in earnings quality, there is still significant variability that cannot be explained by the variables studied. Therefore, these results emphasize the importance of considering other factors that may influence the quality of a company's earnings.

### **Discussion**

#### **The Influence of Earnings Persistence on earnings quality**

The statistical analyses demonstrate a negative relationship between earnings persistence (PL) and earnings quality. According to the data in Table 5, the profit persistence (PL) exhibits a t-calculated value of -0.145200, yielding a significance value of 0.8632. This significance value is above the threshold of 0.05. Consequently, it may be deduced that the research findings have contradicted the hypothesis (H1), positing that there is a relationship between earnings persistence and earnings quality. According to Mubarok & Abdullah (2017), profit persistence is an important measure that can accurately reflect a company's ability to maintain consistent levels of profitability over an extended period. However, a negative association could emerge between earnings' durability and results' reliability due to the natural variability in a company's profits across various financial periods. There are instances where a company experiences a significant profit increase in one fiscal year and a subsequent decrease in the following fiscal year. Companies sometimes engage in profit manipulation as a means to maintain their profitability. Earnings manipulation, or earnings management, is a common practice observed in corporate management (Afni et al., 2014). Implementing these procedures may result in a decline in the accuracy of outcomes, mainly when the information shown in the earnings report no longer faithfully reflects the actual profits of the organization. As a result, the reliability of knowledge diminishes, rendering it an unreliable basis for decision-making. It is vital to comprehend the ramifications of earnings management practices in corporate finance. Implementing stringent controls and increasing transparency in financial reporting are essential to ensuring the precision of information disseminated to corporate stakeholders. This investigation's findings align with those of a prior study by Afni et al. (2014) about industrial enterprises listed on the Indonesia Stock Exchange from 2010 to 2012. The study's findings indicate a significant negative effect of earnings persistence on the quality of earnings. However, the research conducted by Ardianti (2018) on industrial firms listed on the IDX during 2012-2016 produced divergent results, suggesting a positive association between earnings persistence and the quality of profits.

The statistical test results suggest a negative relationship between firm size and the quality of earnings. Based on the findings in Table 5, the t-value for the variable "firm size" is -0.895258, with a corresponding significance level of 0.3514. It is worth noting that the significance level of 0.3514 exceeds the commonly accepted threshold of 0.05. Hence, it can be deduced that the results of this investigation refute the proposed hypothesis (H2), positing that "the size of a company influences the quality of its earnings." As the size of a firm expands, there is a tendency for the level of discretionary accruals to rise, resulting in a decline in

earnings quality. The presented statistics support previous study findings that indicate a little negative influence of firm size on earnings quality, but this effect is not statistically significant. Strong executives may employ earnings management tactics to manipulate financial reporting to achieve more substantial profit goals. However, engaging in this endeavor also involves increased financial risks, which might affect the overall stability of income. The existence of diminished earnings quality within major organizations may engender doubt regarding the reliability of the financial information disclosed to stakeholders. Therefore, it is crucial to enforce more stringent laws and improve the transparency of financial reporting in large organizations to ensure the accuracy of the reported information. Moreover, additional, comprehensive research is necessary to acquire a more profound comprehension of the association between the magnitude of a corporation, its strategies for for-profit management, and the integrity of its financial gains. This will facilitate the provision of a comprehensive comprehension of the factors that influence the overall caliber of a company's earnings. The results of this study are consistent with the research conducted by Novianti (2012), which suggests that the size of a company does not significantly influence the quality of its profitability. In essence, the size of a firm, whether large or small, does not serve as a determining factor for the level of excellence in its earnings quality. According to the findings of Setiawan (2017), a positive association was observed between the size of a company and the level of investor confidence in making investment decisions. Nevertheless, small-scale businesses can generate optimal profits for investors. This finding suggests that investors exhibit a lack of preference for the scale of a firm, as the magnitude of a business does not necessarily exhibit a positive relationship with its level of profitability.

The results of statistical testing suggest that leverage has a negative effect on the quality of earnings. According to the findings in Table 5, the t-calculated value for the company's size is 4.548781, and it is associated with a significance value of 0.001. This significance value is below the conventional threshold of 0.05, suggesting a statistically significant relationship between the company's size and the variable under investigation. Thus, it can be deduced that the results of this study provide evidence in favor of the hypothesis (H3) positing that "leverage exerts an influence on profitability." Identifying the significant influence of leverage on profit quality supports the importance of maintaining an optimal capital structure to maximize financial performance. Companies with a significant reliance on debt are more susceptible to heightened risks due to their necessity to pay interest and meet more extensive financial commitments. Moreover, an excessive reliance on debt can indicate a lack of financial flexibility, compromising the organization's long-term viability. In the context of capital structure, when a firm's debt exceeds the optimal threshold, additional debt might create other financial commitments that hinder the company's profitability. Therefore, the firm's management must prioritize financial risk management and develop appropriate strategies for efficiently managing the capital structure, thereby maintaining a balanced relationship between debt and equity. Decisions about corporate finance must be taken following a thorough evaluation of the organization's ability to manage debt obligations and uphold adequate financial flexibility to foster sustainable long-term growth. The research findings are consistent with the study conducted by Listyawan (2017), indicating that leverage has a significant influence on the quality of earnings. The level or extent of a corporation's debt in financing its activities impacts the caliber of its profits.

## Conclusions

The performed study reveals that the variable of Leverage has a significant effect on the quality of profits. However, earnings persistence and business size do not significantly impact



earnings quality statistically. However, it is crucial to acknowledge that this study is subject to several limitations that may affect the precision and generalizability of the findings. The collection of data samples limits the present analysis during a relatively short observation period of four years. This constraint arises from the restricted data availability due to the COVID-19 epidemic, which resulted in the closure of the Indonesian Stock Exchange in 2020. The issue above has implications for the time limitations associated with data representation. The temporal period under consideration spans from 2019 to 2022. Moreover, the study's limitations are exacerbated by excluding other potential factors that may influence the quality of earnings. This is because the research only incorporated three specific independent variables. Additionally, it should be noted that a limitation of this study is the limited sample size, comprising just 123 observations. The limited sample size could hinder the generalization of the findings to a larger population. Therefore, to provide more inclusive and applicable conclusions, it is recommended to do more research that encompasses a broader range of periods, incorporates more relevant independent variables, and utilizes randomly selected samples from additional industrial sectors. By embracing this methodology, scholarly inquiry will be able to provide a comprehensive and reliable comprehension of the diverse factors that influence the financial viability of manufacturing firms holistically.

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