

THE EFFECT OF PROFITABILITY AND MANAGERIAL ABILITY ON EARNINGS QUALITY WITH AUDIT QUALITY AS A MODERATING VARIABLE: EVIDENCE FROM INDONESIA

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ABSTRACT

This study examines the impact of profitability and managerial ability on earnings quality, with audit quality as a moderating variable. Using a sample of 204 firm-year observations from industrial sector companies listed on the Indonesia Stock Exchange (2021–2024), this research applies multiple linear regression and moderation analysis. The findings reveal that profitability and managerial ability have significant negative effects on earnings quality. Additionally, audit quality does not significantly moderate these relationships. These results suggest that higher profitability and managerial efficiency may incentivize earnings management practices, thereby reducing earnings quality. This study contributes to the literature by highlighting the complex role of internal performance and external audit mechanisms in financial reporting quality.

Keywords: Earnings Quality, Profitability, Managerial Ability, Audit Quality

1. Introduction

Earnings quality plays a fundamental role in financial reporting as it reflects the reliability, transparency, and sustainability of a firm’s financial performance. High-quality earnings are essential for investors, regulators, and stakeholders, as they provide a reliable basis for forecasting future cash flows and assessing firm value. However, in practice, earnings quality is often compromised due to managerial opportunism and information asymmetry, particularly in emerging markets.

The phenomenon of declining earnings reliability is evident in several corporate cases where firms report significant fluctuations in profits despite receiving unqualified audit opinions. Such conditions raise concerns regarding the effectiveness of external monitoring mechanisms and the credibility of financial statements. As indicated in the underlying thesis, the persistence of earnings manipulation issues demonstrates that profitability alone does not necessarily guarantee high-quality reporting.

Although prior studies have generally suggested that profitability and managerial ability improve earnings quality, empirical findings remain inconsistent. Furthermore, the moderating role of audit quality has not been sufficiently explored, particularly in the context of developing economies. Therefore, this study aims to provide a more comprehensive analysis by integrating these variables into a unified empirical framework.

2. Literature Review and Hypothesis Development

2.1 Agency Theory

According to Jensen and Meckling (1976), agency conflicts arise due to differences in interests between principals and agents. Managers may manipulate earnings for personal gain, leading to reduced earnings quality.

Agency theory posits that conflicts arise between principals and agents due to differences in objectives and asymmetric information. Managers, who possess superior knowledge about the firm's operations, may engage in opportunistic behavior to maximize their personal benefits, even if such actions are detrimental to shareholders. This opportunistic behavior often manifests in earnings management practices, where managers manipulate financial reports to meet performance targets or secure compensation incentives.

In this context, profitability may intensify agency conflicts because higher earnings increase expectations from stakeholders, thereby motivating managers to sustain performance through discretionary accounting practices. Consequently, profitability may not always translate into improved earnings quality.

2.2 Signaling Theory

Signaling theory explains how managers communicate firm quality to external stakeholders through financial information. Profitability and managerial efficiency are often interpreted as positive signals of firm performance. However, these signals can become unreliable when they are influenced by earnings manipulation. Without credible verification mechanisms, such as high-quality audits, the signals transmitted by financial statements may mislead investors.

2.3 Earnings Quality

Earnings quality is defined as the extent to which reported earnings reflect the firm's true economic performance. In this study, earnings quality is measured using the Quality of Income Ratio, which compares operating cash flows to net income. A higher ratio indicates that earnings are supported by actual cash flows, suggesting greater reliability and sustainability.

2.4 Profitability and Earnings Quality

Profitability is commonly measured using Return on Assets (ROA), which reflects a firm's ability to generate earnings from its assets. While profitability is generally associated with efficient resource utilization, it may also create incentives for managers to engage in earnings management to maintain consistent performance levels. Therefore, the relationship between profitability and earnings quality remains ambiguous and warrants empirical investigation.

2.5 Managerial Ability and Earnings Quality

Managerial ability refers to the competence of managers in utilizing resources effectively to achieve organizational objectives. Although capable managers are expected to enhance operational efficiency, they may also possess the expertise required to manipulate financial reports more effectively. As a result, higher managerial ability does not necessarily guarantee improved quality earnings.

2.6 Audit Quality as a Moderating Variable

Audit quality is defined as the likelihood that auditors detect and report material misstatements. High-quality audits are expected to enhance financial reporting credibility by reducing information asymmetry and limiting managerial opportunism.

However, in emerging markets, the effectiveness of audit quality may be constrained by institutional weaknesses and regulatory limitations.

3. Methodology

3.1 Data and Sample

The study utilizes secondary data collected from financial reports of industrial firms listed on the Indonesia Stock Exchange between 2021 and 2024. The final sample consists of 204 firm-year observations selected through purposive sampling criteria. The empirical analysis is conducted using multiple regression models, including a moderated regression framework to assess interaction effects.

3.2 Variables

Table 3.1 Variable Definitions

Variable	Type	Measurement	Source
Earnings Quality (KL)	Dependent	Quality of Income Ratio	Dechow et al. (2010)
Profitability (PROF)	Independent	Return on Assets (ROA)	
Managerial Ability (KM)	Independent	Total Asset Turnover (TATO)	
Audit Quality (KA)	Moderating	Big Four Dummy	DeAngelo (1981)

3.3 Model Specification

Model 1

$$KL = \alpha + \beta_1 PROF + \beta_2 KM + \beta_3 KA + \beta_4 GROW + \beta_5 LEV + \beta_6 LIK + \beta_7 SIZE + \varepsilon$$

Variables explanation:

KL	= Kualitas Laba
A	= Konstanta
$\beta_1, \beta_2, \beta_3, \dots, \beta_7$	= Koefisien Variabel
PROF	= Profitabilitas
KM	= Kemampuan Manajerial
KA	= Kualitas Audit
GROW	= Sales Growth
LEV	= Leverage (Debt-to-Assets ratio)
LIK	= Likuiditas (Current Ratio)
SIZE	= Firm Size (Total Assets)
ε	= Residual Error

Model 2 (Moderation)

$$KL = \alpha + \beta_1 PROF + (\beta_2 PROF * KA) + \beta_3 KM + (\beta_4 KM * KA) + \beta_5 GROW + \beta_6 LEV + \beta_7 LIK + \beta_8 SIZE + \varepsilon$$

4. Results

4.1 Descriptive Statistics

The descriptive statistics presented in Table 1 indicate that the average earnings quality (EQ) is 1.12, suggesting that, on average, firms generate earnings supported by operating cash flows. However, the relatively high standard deviation of 0.65 indicates significant variability across firms. The descriptive statistics provide an overview of the distribution and variability of the variables used in this study. Earnings quality (EQ), measured using the Quality of Income Ratio, has a mean value above one, indicating that, on average, firms generate earnings supported by operating cash flows. However, the relatively high standard deviation suggests considerable variability across firms, which reflects differences in financial reporting practices and operational efficiency.

Profitability (ROA) shows moderate variation across firms, indicating that the sampled companies exhibit differing levels of financial performance. Managerial ability, proxied by Total Asset Turnover, also demonstrates variability, suggesting differences in how efficiently firms utilize their resources. Audit quality, measured as a dummy variable for Big Four auditors, indicates that not all firms employ high-reputation auditors

Table 4.1 Descriptive Statistics

Variable	Mean	Std Dev	Min	Max
EQ	1.12	0.65	0.21	3.45
PROF	0.082	0.045	0.01	0.21
MA	1.35	0.72	0.34	3.10
AQ	0.42	0.49	0	1

The data indicate that profitability levels are relatively modest, while managerial ability varies considerably across firms.

4.2 Correlation Analysis

The correlation matrix reveals a statistically significant negative relationship between profitability and earnings quality, as well as between managerial ability and earnings quality.

This preliminary finding suggests that higher profitability and managerial efficiency may not necessarily translate into higher reporting quality. Instead, it indicates the potential presence of opportunistic behavior, where managers manipulate earnings despite strong performance. These findings suggest that higher performance may be associated with lower reporting reliability.

4.3 Classical Assumption Tests

Before conducting regression analysis, several classical assumption tests were performed to ensure the validity and reliability of the model.

4.3.1 Normality Test

The normality test was conducted using both the Kolmogorov–Smirnov test and the Shapiro–Wilk test, supported by graphical analysis through histogram and Normal P–P Plot. The results indicate that the residuals are normally distributed, as the significance values exceed 0.05. Additionally, the histogram displays a bell-shaped distribution, and the P–P Plot shows points closely aligned with the diagonal line. This finding confirms that the regression model satisfies the normality assumption, which is essential for ensuring unbiased and efficient parameter estimation.

4.3.2 Multicollinearity Test

The multicollinearity test was performed using Variance Inflation Factor (VIF) and tolerance values. The results show that all VIF values are below the threshold of 10, and tolerance values are above 0.10.

These findings indicate that there is no multicollinearity among the independent variables. Therefore, each variable contributes uniquely to the model without significant overlap, ensuring the stability and interpretability of the regression coefficients.

4.3.3 Heteroskedasticity Test

The heteroskedasticity test was conducted using the Glejser test. The results show that all independent variables have significance values greater than 0.05, indicating the absence of heteroskedasticity.

This implies that the variance of the residuals is constant across observations, meaning that the model satisfies the homoscedasticity assumption. As a result, the regression estimates are reliable and not biased due to unequal error variances.

4.3.4 Autocorrelation Test

The Durbin–Watson statistic was used to detect autocorrelation in the residuals. The obtained value is approximately 1.89, which falls within the acceptable range of 1.5 to 2.5.

This result indicates that there is no autocorrelation problem in the model. Consequently, the residuals are independent, which is crucial for the validity of regression analysis, particularly in panel data studies.

4.4 Regression Analysis

4.4.1 Model Fit (F-Test and R^2)

The F-test results show that the regression model is statistically significant at the 1% level ($p < 0.001$), indicating that the independent variables collectively explain variations in earnings quality.

The R^2 value indicates that approximately 40% of the variation in earnings quality is explained by the model. This suggests that while the model has

moderate explanatory power, there are additional factors outside the model that may influence earnings quality.

4.4.2 Hypothesis Testing (t-Test)

Effect of Profitability on Earnings Quality.

The regression results indicate that profitability has a negative and statistically significant effect on earnings quality. This finding contradicts the initial hypothesis, which predicted a positive relationship. This result suggests that firms with higher profitability are more likely to engage in earnings management practices. Managers may manipulate earnings to maintain consistent performance or meet market expectations. This behavior aligns with agency theory, which posits that managers act in their own interests when there is information asymmetry (Jensen & Meckling, 1976). Furthermore, this finding is consistent with prior studies indicating that high-performing firms may have stronger incentives to smooth earnings (Healy & Wahlen, 1999).

Effect of Managerial Ability on Earnings Quality.

The results also show that managerial ability has a negative and significant effect on earnings quality. This finding challenges the assumption that more capable managers always produce higher-quality financial reports. Instead, the results suggest that managers with higher ability may use their expertise to manipulate earnings more effectively. This supports the argument that managerial ability can facilitate opportunistic behavior, particularly in environments with weak monitoring mechanisms (Demerjian et al., 2012).

4.5 Moderation Analysis (Audit Quality)

The moderated regression analysis reveals that audit quality does not significantly moderate the relationship between profitability and earnings quality, nor between managerial ability and earnings quality.

The interaction terms are statistically insignificant, indicating that the presence of Big Four auditors does not strengthen or weaken the relationships.

Table 4.2 Regression Results (Model 1)

Variable	Coefficient	t-value	Sig
PROF	-0.842	-3.91	0.000
MA	-0.615	-2.87	0.005
AQ	0.072	0.88	0.381
Controls	Included		

The regression results demonstrate that profitability has a statistically significant negative effect on earnings quality. This finding indicates that firms with higher profitability tend to report lower-quality earnings. One possible explanation is that

managers in highly profitable firms face greater pressure to maintain performance levels, leading to increased earnings management.

Similarly, managerial ability is found to negatively influence earnings quality. This result suggests that more capable managers may utilize their expertise to engage in sophisticated earnings manipulation techniques, thereby reducing the reliability of financial reporting.

Table 4.3 Moderation Results (Model 2)

Variable	Coefficient	t-value	Sig
PROF × AQ	0.081	0.94	0.349
MA × AQ	0.067	0.72	0.473

The interaction terms between audit quality and both profitability and managerial ability are not statistically significant. This indicates that audit quality does not strengthen or weaken the relationships between the independent variables and earnings quality.

4.5 Discussion

The results indicate that higher profitability and managerial ability are associated with lower earnings quality. This suggests that firms with strong performance may engage in earnings management practices. Audit quality does not significantly moderate these relationships, indicating that external auditing may not be sufficient to constrain earnings manipulation.

The findings of this study provide important insights into the complex dynamics of earnings quality. The negative relationship between profitability and earnings quality suggests that higher financial performance may create incentives for earnings manipulation rather than transparency. This result aligns with agency theory, which emphasizes the role of managerial opportunism in financial reporting.

Furthermore, the negative effect of managerial ability on earnings quality challenges the conventional assumption that competent managers always enhance reporting quality. Instead, the results indicate that managerial expertise may be used strategically to manage earnings, particularly in environments with weak monitoring mechanisms.

The absence of a moderating effect of audit quality raises concerns regarding the effectiveness of external auditing in emerging markets (DeFond & Zhang, 2014). Although Big Four auditors are generally associated with higher audit quality, their presence does not appear to significantly constrain managerial opportunism in this context

5. Conclusion

This study concludes that profitability and managerial ability have significant negative effects on earnings quality, while audit quality does not play a moderating role. These

findings suggest that traditional governance mechanisms may be insufficient to ensure high-quality financial reporting in emerging markets.

This study set out to examine the effect of profitability and managerial ability on earnings quality, while also evaluating the moderating role of audit quality within the context of industrial firms listed on the Indonesia Stock Exchange during the 2021–2024 period. Using a robust empirical framework that includes multiple regression and moderated regression analysis, the study provides several important findings that contribute to the understanding of financial reporting behavior in emerging markets.

First, the results indicate that profitability has a statistically significant negative effect on earnings quality. This finding contradicts the conventional expectation that higher profitability reflects stronger financial performance and, consequently, more reliable reporting. Instead, the results suggest that firms with higher profitability may face stronger incentives to engage in earnings management practices in order to sustain performance levels and meet stakeholder expectations. This outcome aligns with the agency theory perspective, which posits that managers may act opportunistically when there is information asymmetry and performance pressure (Jensen & Meckling, 1976; Healy & Wahlen, 1999).

Second, the study finds that managerial ability also has a significant negative effect on earnings quality. This result challenges the widely held assumption that more capable managers inherently produce higher-quality financial reports. Rather, the findings indicate that managerial competence may enable more sophisticated forms of earnings manipulation, as skilled managers possess greater knowledge of accounting systems and operational processes. This interpretation is consistent with the argument presented by Demerjian et al. (2012), who emphasize that managerial ability can influence both operational efficiency and reporting discretion.

Third, the results reveal that audit quality does not significantly moderate the relationship between profitability and earnings quality, nor between managerial ability and earnings quality. This suggests that the presence of high-quality auditors, as proxied by Big Four affiliation, is not sufficient to mitigate opportunistic reporting behavior in this context. The absence of a moderating effect raises concerns regarding the effectiveness of external auditing as a governance mechanism, particularly in emerging markets where institutional enforcement may be weaker (DeFond & Zhang, 2014).

Overall, the findings of this study provide strong empirical support for agency theory while simultaneously challenging key assumptions of signaling theory. Specifically, the results indicate that financial performance indicators such as profitability may not serve as reliable signals of firm quality when they are subject to manipulation. Furthermore, the findings suggest that audit quality, as commonly measured, may not be an effective tool for ensuring transparency and accountability in financial reporting.

5.2 Theoretical Implications

The findings of this study offer several important contributions to the theoretical literature on earnings quality, corporate governance, and financial reporting. From an agency theory perspective, the results reinforce the notion that conflicts of interest

between managers and shareholders remain a fundamental issue in corporate governance. The negative relationship between profitability and earnings quality suggests that higher performance may exacerbate agency problems rather than mitigate them. This finding extends prior research by demonstrating that profitability can act as a trigger for opportunistic behavior, particularly in environments characterized by weak monitoring mechanisms.

In relation to managerial ability, the study contributes to the ongoing debate regarding the role of managerial competence in financial reporting. While previous literature has often emphasized the positive effects of managerial ability on firm performance, this study highlights its potential downside. Specifically, the results suggest that managerial ability may increase the capacity for earnings manipulation, thereby reducing earnings quality. This finding provides a more nuanced understanding of managerial behavior and underscores the need to consider both the benefits and risks associated with managerial expertise.

With respect to signaling theory, the study challenges the assumption that financial indicators such as profitability function as credible signals of firm quality. The results indicate that these signals may be distorted by managerial discretion, thereby reducing their reliability. Furthermore, the lack of a significant moderating effect of audit quality suggests that external verification mechanisms may not be sufficient to restore signal credibility in all contexts.

5.3 Practical Implications

The findings of this study have important implications for various stakeholders, including investors, regulators, auditors, and corporate managers.

For investors, the results highlight the need for caution when interpreting financial performance indicators such as profitability. The negative relationship between profitability and earnings quality suggests that high profits do not necessarily reflect strong underlying performance. Therefore, investors should complement profitability analysis with additional indicators, such as cash flow measures and earnings quality metrics, in order to make more informed investment decisions.

For regulators, the findings underscore the importance of strengthening corporate governance frameworks and enhancing the effectiveness of financial reporting oversight. The lack of a moderating effect of audit quality suggests that current regulatory mechanisms may not be sufficient to deter earnings management practices. As such, regulators may need to implement stricter audit standards, increase enforcement efforts, and promote greater transparency in financial reporting.

For auditors, the results raise important questions regarding the effectiveness of audit processes in detecting and preventing earnings manipulation. Although Big Four auditors are generally associated with higher audit quality, their presence does not appear to significantly influence earnings quality in this study. This suggests that auditors may need to adopt more rigorous audit procedures and enhance their professional skepticism in order to improve audit effectiveness.

For corporate managers, the findings highlight the ethical and reputational risks associated with earnings management. While short-term performance manipulation may provide temporary benefits, it can ultimately undermine stakeholder trust and damage the firm’s long-term value. Therefore, managers should prioritize transparency and accountability in financial reporting practices.

5.4 Policy Implications

From a policy perspective, the study suggests that improving earnings quality requires a multifaceted approach that goes beyond relying solely on audit quality. Policymakers should consider strengthening internal governance mechanisms, such as audit committees and board oversight, in addition to enhancing external monitoring systems.

Furthermore, there is a need to improve the institutional environment in which firms operate. This includes strengthening legal enforcement, enhancing investor protection, and promoting a culture of transparency and accountability. By addressing these structural issues, policymakers can create an environment that discourages opportunistic behavior and supports high-quality financial reporting.

5.5 Limitations and Future Research

Despite its contributions, this study has several limitations that should be acknowledged. First, the study focuses on a single sector and country, which may limit the generalizability of the findings. Future research could extend the analysis to other sectors or countries in order to provide a more comprehensive understanding of earnings quality dynamics.

Second, the study uses proxy variables to measure key constructs such as managerial ability and audit quality. While these proxies are widely used in the literature, they may not fully capture the complexity of these concepts. Future research could explore alternative measurement approaches to provide more nuanced insights.

Third, the study focuses on quantitative analysis and does not consider qualitative factors such as corporate culture or managerial ethics. Future studies could incorporate qualitative methods to better understand the underlying motivations behind earnings management behavior.

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