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GOVERNANCE AND AUDIT QUALITY: CAN IMPROVE EARNINGS QUALITY?

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ABSTRACT

Purpose: *This study aims to examine the effect of governance structure and audit quality on earnings quality.*

Methodology/Approach: *74 manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2011 to 2019 was selected using purposive sampling and used to test the hypotheses. The data was analyzed using OLS within multiple linear regression approach.*

Findings: *Regression results showed independent commissioners and numbers of audit committee meetings improved earnings quality in large-sized manufacturing companies. This study also found that institutional ownership has no effect on earnings quality. Likewise, audit quality, as reflected by size of the public accounting firm, has no effects on earnings quality.*

Practical Implications: *The results provide information about the importance of independent commissioners in keeping good earnings quality. These findings can be used either by the government or investors to strengthen the role of independent commissioners. Also, the government can regulate the minimum number of audit committee meetings to overcome low-income quality problems.*

Originality/value: *This study proved that internal independence mechanism is the crucial one to attain a high level of earnings quality. Also, this study differentiates the effect of predictors by company's size.*

KEYWORDS: *Audit Committee; Audit Quality; Corporate Governance Structure; Earnings Quality; Independent Commissioners.*

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ABSTRAK

Tujuan penelitian: Penelitian ini bertujuan untuk menguji pengaruh struktur tata kelola dan kualitas audit pada kualitas laba.

Metode/Pendekatan: 74 perusahaan manufaktur yang terdaftar pada Bursa Efek Indonesia (BEI) sejak tahun 2011 hingga 2019 dipilih dengan menggunakan purposive sampling dan digunakan untuk menguji hipotesis. Data dianalisis menggunakan OLS dalam pendekatan regresi linear berganda.

Hasil: Hasil regresi menunjukkan komisaris independen dan jumlah rapat komite audit meningkatkan kualitas audit pada perusahaan manufaktur berukuran besar. Riset ini juga menemukan bahwa kepemilikan institusional tidak berdampak pada kualitas laba. Demikian juga kualitas audit yang direfleksikan oleh ukuran kantor akuntan publik tidak berdampak pada kualitas laba.

Implikasi praktik: Hasil tersebut memberikan informasi tentang pentingnya komisaris independen guna mempertahankan kualitas laba yang baik. Temuan ini dapat digunakan baik oleh pemerintah maupun investor untuk memperkuat peran komisaris independen. Kemudian, pemerintah juga dapat mengatur jumlah minimal pertemuan komite audit untuk mengatasi permasalahan rendahnya kualitas laba.

Orisinalitas/kebaharuan: Riset ini membuktikan bahwa mekanisme independensi internal merupakan hal yang paling krusial untuk mencapai kualitas laba tingkat tinggi. Riset ini juga membedakan dampak dari variabel prediktor berdasarkan ukuran perusahaan.

KATA KUNCI: Komite Audit; Komisaris Independen; Kualitas Audit; Kualitas Laba; Struktur Tata Kelola.

INTRODUCTION

One of the important pieces of information conveyed by financial reports is earnings because it is able to reflect a company's performance (Dichev et al., 2016). This is because earnings are related to a company's earning power in the future, as well as being the basis for determining management compensation and dividends (SFAC No. 1, later replaced by SFAC No. 8).

An accounting fraud scandal that occurred in Indonesia in February 2015 was a case where earnings information was being manipulated by PT Inovisi Infracom (INVS). The IDX found eight items in INVS's financial statements for the September 2014 period which had to be corrected due to misstatements: earnings per share of PT INVS appeared to be larger than they should have been. As a result, the IDX suspended trading in INVS shares in February and May 2015.

Another case of earnings management involved PT Tiga Pilar Sejahtera Food Tbk (AISA) and its 2017 financial statement. Ernst & Young Indonesia (EY) conducted a fact-based investigation of AISA's new management dated 12 March 2019 for alleged inflation of accounting items by PT Tiga Pilar during 2017. EY found an overstatement of IDR 4 trillion in AISA's accounts receivable, inventories, and fixed assets. In addition, the overstatement on the sales account was IDR 662 billion, and EBITDA (earnings before interest, taxes, depreciation, and amortization) was IDR 329 billion. This confirmed EY's suspicion that the company was carrying out earnings management to make its net loss appear smaller than it actually was in order to keep the company's value from decreasing in the eyes of investors (Kusuma & Mertha, 2021)

This phenomenon of earnings management indicates the failure of financial reports to meet the needs for information of their users. If manipulated, earnings information—which is an important component in financial statements—does not present actual facts about the company's financial condition, meaning that the quality of the information needed for decision-making is questionable.

Earnings quality refers to stability, persistence, and non-fluctuating figures with regard to earnings. Quality earnings must reflect the underlying intrinsic value of a company, namely accruals. In calculating earnings, different estimates and assessments are needed according to the characteristics of each company. Errors in estimates and judgments can lead to corrections in the future, so current earnings cannot be used as a reference for projecting future earnings (Yulianda, 2017). Earnings are said to have quality when there is no gap between accruals and cash flows (Dichev et al., 2016) so it can be said that accruals reflect future cash flows that will be realized correctly.

The main objective of this study is to determine the quality of earnings presented in financial statements. This information is expected to assist stakeholders in making decisions. The model used to measure earnings quality is the accrual quality model developed by Dechow and Dichev (2002). This model has been widely accepted as a tool for detecting and measuring earnings manipulation and uncertainty about accruals (Dechow et al., 2010)

In order to maximize earnings quality and avoid earnings-manipulation practices that can provide misleading information to stakeholders, companies believe that the implementation of corporate governance (CG) is a way to uphold—and represent the company's commitment to—business ethics and work ethics (Rini & Ghozali, 2012). Optimal implementation of CG mechanisms is influenced by the extent to which a company has identified and implemented a corporate governance structure that is appropriate for the size of its business. (Boone et al., 2007) found that company size is one of the factors that influence the choice of corporate governance structure. In addition, the relative costs arising from the implementation of a formal corporate governance structure are substantially smaller for large companies than for small companies (Linck et al., 2008). This is caused by the fact that, the larger the size of the company, the greater the incentives that will be given to management when adopting good corporate governance (Kent et al., 2016).

According to the National Committee on Governance Policy (Indonesian: KNKG), the effective implementation of GCG requires a general meeting of shareholders (GMS), as well as boards of commissioners and directors (including supporting committees that operate under them). The research results do not always show that effective governance is related to earnings quality. Independent commissioners have an effect on earnings management (Eva and Khoiruddin, 2016), and audit committees have an impact on earnings quality. An effective audit committee is an important component in achieving good corporate

governance. Conversely, independent commissioners have no impact on earnings management (Taruno, 2013) and audit committees (Nabila & Daljono, 2013) and have no impact on earnings quality (Farida & Kusumumaningtyas, 2017; Rilo & Laksito, 2017).

Earnings quality can be a result of institutional ownership and good audit quality. Teoh and Wong (1993) found that the Big 4 auditors have higher audit quality than non-Big 4 auditors. Besides this, the Big 4 auditors with industry specialization have higher audit quality than the Big 4 auditors without industry specialization (Balsam et al., 2003; Behn et al., 2008; Knechel et al., 2007; Romanus et al., 2008). Differences in earnings quality are also influenced by variations in the credibility of auditors in conducting audits, as well as the quality of the audits they provide (Herusetya, 2014). This study also found that the Big 4 and non-Big 4 are not consistently different. The difference in past research findings opens questions about whether audit quality is truly affecting earnings quality or not. There is possible contingency where audit quality is dependent on the situation (or context) of the firms and its environment (Firnanti & Pirzada, 2019; Hasan et al., 2020; Khalil & Ozkan, 2016).

The purpose of this study is to examine the influence of corporate governance structure (comprising independent commissioners, audit committee meetings, and institutional ownership) and audit quality (projected by the Big 4 auditors) on earnings quality. This study refers to Kent et al (2016) who used the model formulated by McNichols (2002) which was an integration of the model of Jones and the model of Dechow and Dichev. This research takes different approach in measuring earnings quality from previous literature because Indonesian stock market (IDX) possessed non-semi strong market form. As a result, market can not process information about earnings quality correctly and cover up the actual quality of firm's reported earnings (Herusetya, 2014).

Agency theory is a conceptualization of the relationship between agent and principal and it aims to protect the principal's interests from moral hazard problems and information asymmetry. Therefore, a control mechanism is needed that is able to narrow the differences between the goals and interests of the principal and the agent. A good corporate governance (GCG) mechanism is a system that can control the company, thus providing added value for all stakeholders (Monks & Minow, 2011). With this mechanism, management is expected to be able to fulfill its obligation to disclose company performance by paying attention to accuracy, transparency, and timeliness, as well as fulfilling the rights of stakeholders to obtain correct and timely information (Kaihatu, 2006).

The KNKG stated that the management of a limited liability company in Indonesia adheres to a two-board system that clearly divides the authorities and responsibilities between the board of commissioners and board of directors in accordance with the articles of association and statutory regulations. In this case, the authority to appoint and dismiss directors rests with the GMS. This results in the position of the board of commissioners being equal to that of the board of directors. The two-board system model in Indonesia can be described as follows.

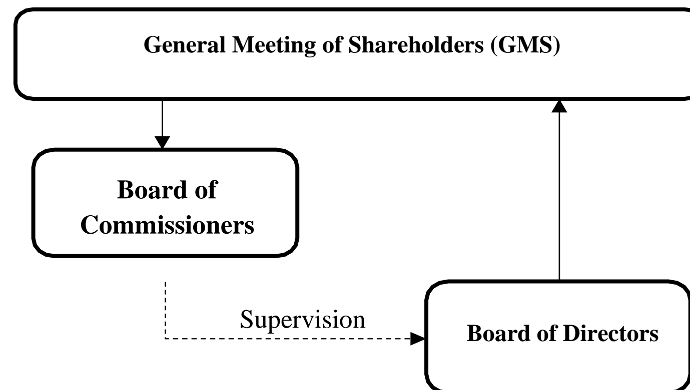

Figure 1. Two-board system used in Indonesia

Source: FCGI (2001)

The research framework is presented in Figure 2, as follows:

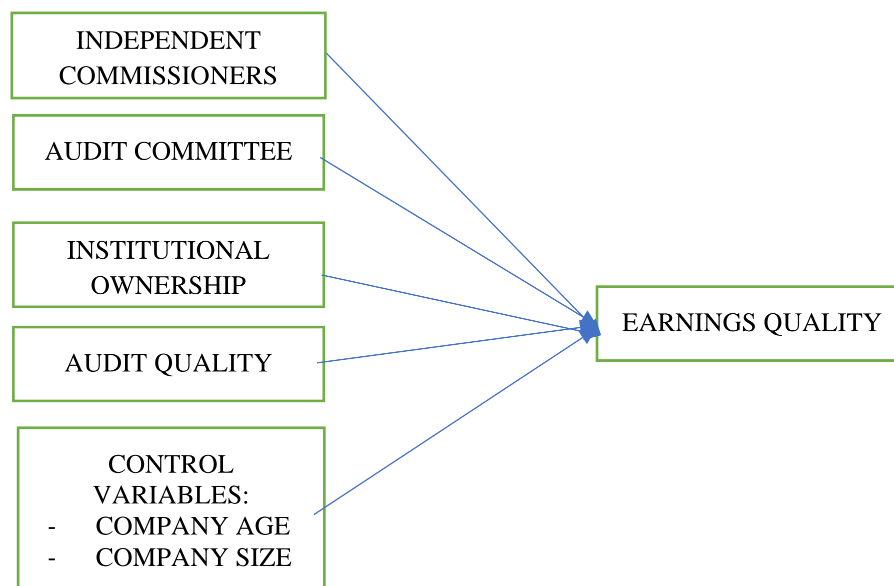

Figure 2. Research Framework

Independent Commissioners and Earnings Quality

The board of commissioners is the essence of corporate governance because of its role in ensuring the implementation of corporate strategy, supervising management's running of the company, and ensuring accountability. Thus, it can be said that the board of commissioners is the center of corporate resilience and success.

The Indonesia Stock Exchange (IDX), in its Decree of the Directors of PT BEJ No: Kep-305/BEJ/07-2004, requires listed companies to have independent commissioners whose number is proportional to the number of shares owned by non-controlling shareholders provided that the number of independent commissioners is at least 30 percent of the total number of commissioners. This is to reduce any agency problems. The composition of the board of commissioners can reduce earnings management and increase earnings quality (Mustaqomah, 2011). Therefore, the first hypothesis is formulated as follows:

H_1: *Independent commissioners have a positive effect on earnings quality*

Earnings Quality and Audit Committee

According to the Indonesian Audit Committee Association, the audit committee is an independent and professional committee formed by the board of commissioners to

strengthen the oversight function with regard to financial reporting, risk management, audit implementation, and implementation of corporate governance within a company. Audit committees, as part of the implementation of good corporate governance in companies, have a positive effect on increasing earnings quality (Kent et al., 2016) and the number of audit committee meetings can increase earnings quality (Puteri & Rohman, 2012).

When an audit committee functions effectively, control over the company will increase and agency conflicts arising from opportunistic actions on the part of management can be minimized (Adriani & Syafruddin, 2011). Based on the description above, the following hypothesis proposed:

H_2: *The audit committee has a positive effect on earnings quality*

Institutional Ownership and Earnings Quality

Institutional ownership is one tool that can reduce agency conflict. Jensen and Meckling (1976) stated that the higher the degree of institutional ownership, the stronger the control exercised by external parties over the company will be. The higher the percentage of institutional ownership of shares in a company, the higher the quality of the earnings generated (Muid, 2009; Puteri & Rohman, 2012).

A large degree of institutional ownership is also seen as being capable of hindering the opportunistic behavior of management. This is the result of the involvement of institutional investors in strategic decision-making because such investors are not easily manipulated by earnings management actions (Jensen & Meckling, 1976). Thus, the hypothesis that can be put forward is as follows:

H_3: *Institutional ownership has a positive effect on earnings quality*

Audit Quality and Earnings Quality

One of the determinants of audit quality is the size of the public accounting firm (PAF). According to Sopian (2014), audit quality can be measured by how much power the auditor has to limit management's techniques in carrying out earnings management. When the audit is carried out by a large and well-reputed PAF, the PAF is considered to have greater ability to prevent opportunistic actions on the part of the management, meaning that the resulting earnings will be of higher quality.

Herusetya (2014) found that there is no consistent evidence of a difference in the quality of earnings as measured by the earnings response coefficient between companies audited by the Big 4 and non-Big 4 PAFs. However, Kent et al. (2016); Sopian (2014) found a positive relationship between PAF size and earnings quality. Thus the hypothesis is made:

H_4: *The size of the public accounting firm (audit quality) has a positive effect on earnings quality*

METHOD

This study refers to Kent et al. (2016) who used financial data from 7 years to generate earnings quality figures for 2018. Therefore, the population in this study comprises public companies listed on the Indonesia Stock Exchange (IDX) during the period 2011 to 2019. The selection of companies engaged in the manufacturing sector for this study's population was due to the various types and sizes of companies in this sector, meaning that the measurement of earnings quality could be carried out while examining companies of various sizes and across sub-sectors. 2011 was selected as base year because IFRS convergence phenomenon started at January 1, 2012 and impacted the majority of firm's accrual calculation and thereof, earnings quality as well (Sari, 2019). 2019 was selected as the last

observation year to exclude the effects of pandemic on firm's earnings. The sample in this study was selected using a purposive sampling method. The sample for calculating earnings quality comprised 518 companies from the 2011-2018 period while testing the hypothesis in 2019 (with annual reports as of the end of 2018) comprised 74 companies.

The variables for governance are independent commissioners, audit committees, audit quality, and institutional ownership. For the measurement of independent commissioners, audit committees, and institutional ownership, this study referred to Kent et al. (2016). For independent commissioners, the percentage of the members of a company's board of commissioners who are independent was used. The audit committee was measured using the number of audit committee meetings listed in a company's annual report. For the measurement of institutional ownership, this study used the percentage of a company's total outstanding shares that are owned by institutions. For audit quality, a dummy variable was used: companies that use the services of Big 4 PAFs were given a score of 1, while companies that use the services of non-Big 4 PAFs were given a score of 0 (Puteri & Rohman, 2012).

Company age is one of the important factors considered by investors before investing because company age reflects the company's ability to survive in the face of the business competition that exists (Bestivano, 2013). The company age control variable uses the formula: **AGE = LN (Company Age in Months)**. Company size is a grouping of companies into several categories, including large-sized companies, medium-sized companies, and small-sized companies (Wati & Putra, 2017). Companies that are classified as large-sized will generally be more transparent in carrying out their operational activities because external parties pay more attention, thereby minimizing the possibility of earnings management practices (Agustia & Suryani, 2018). In this study, company size is measured using the natural logarithm of a company's total assets: **SIZE = LN (Total Assets)**.

One way to measure earnings quality is to use accruals quality which is obtained from the large error rate in company accruals. The measurement of earnings quality in this study uses the model of Dechow and Dichev (2002) for accrual quality measurement, as modified by McNichols (2002). The Dechow and Dichev (2002) model, as modified by McNichols (2002), defines working capital accruals as a mapping of past, present, and future cash flows, as well as the effect of income or sales levels, as well as PPE (i.e. property, plant, and equipment). The error value or residual value of this model is a measure of accrual quality. A low-error value indicates good accrual quality and earnings quality, while a high-error value indicates poor accrual quality and earnings quality. The regression model used to measure accrual quality is as follows:

$$\Delta WCt = \beta_0 + \beta 1 \times CFO_{t-1} + \beta 2 \times CFO_t + \beta 3 \times CFOt+1 + \beta 4 \times \Delta REVt + \beta 5 \times PPEt + \varepsilon 1$$

Key: ΔWCt = changes in working capital accruals in year t which includes changes in accounts receivable, payables, inventories, short-term investments, provisions, and other current assets and current liabilities; CFOt-1 = cash flow form operation in year t-1; CFOt = cash flow from operation in year t; CFOt+1 = cash flow from operations in year t+1; ΔREVt = change in income from operating activities in year t; and PPEt = value of property, plant and equipment reported in year t.

The analytical method used to examine the effect of corporate governance structure and public accounting firm (KAP) size on earnings quality in this study is multiple linear regression analysis, with the equation:

$$AQ = \beta 0 + \beta 1KI + \beta 2RKA + \beta 3INST + \beta 4PAF + \varepsilon 1$$

Key: AQ = Accruals Quality (proxy of earnings quality);; KI = Composition of independent commissioners; RKA = Number of audit committee meetings; INST = Institutional ownership; KAP = Size of public accounting firm; and ε = residual value (error).

RESULTS AND DISCUSSION

Descriptive statistical testing was carried out on the whole sample, then on the large-sized companies cluster, and the medium-sized companies cluster. In this study, it was not possible to get the criteria for small-sized companies, so the testing was carried out on the large-sized and medium-sized companies. The criterion for large companies was that they had more than 250 employees, while for medium-sized companies it was that they had between 50 and 249 employees.

	N	Minimum	Maximum	Mean	Standard Deviation
Accruals Quality	74	0.00	0.15	0.06	0.03
Institutional Ownership	74	0.096	0.998	0.7472	0.20
Independent Commissioners	74	0.29	1.00	0.4392	0.13
Number of Audit Committee Meetings	74	0	22	6.20	4.65
Audit Quality	74	0	1	0.43	0.49
Company Age	74	3.87	7.18	5.6404	0.48
Company Size	74	12	20	14.96	1.73
Large-Sized Companies:					
Accruals Quality	66	0.00	0.15	0.06	0.03
Institutional Ownership	66	0.096	0.998	0.7578	0.20
Independent Commissioners	66	0.29	100.00	0.4398	0.14
Number of Audit Committee Meetings	66	0	22	6.32	4.77
Audit Quality	66	0	1	0.48	0.50
Company Age	66	3.87	7.18	5.6536	0.49
Company Size	66	12	20	15.21	1.66
Medium-Sized Companies:					
Accruals Quality	8	0.00	0.10	0.04	0.03
Institutional Ownership	8	0.365	0.957	0.6593	0.24
Independent Commissioners	8	0.33	0.65	0.4337	0.12
Number of Audit Committee Meetings	8	3	14	5.25	3.57
Audit Quality	8	0	1	0.13	0.35
Company Age	8	4.68	5.89	5.5308	0.47
Company Size	8	12	14	12.88	0.64

Table 1. Descriptive Statistics of all Companies, Large-Sized, and Medium-Sized

According to the descriptive statistics results, the accrual quality has an average value of 0.06, which means that, in general, the company has good quality because the value is close to zero (0). That is, in general, the company is able to estimate accruals that are close to its realized cash flows. This happened in the test of the whole sample, as well as in the tests of the clusters of large-sized and medium-sized companies.

The governance variables—that is the independent commissioners, audit committee, and institutional ownership—show a distribution of data that has a standard deviation that is not too high. The institutional ownership variable indicates that the majority of the ownership is institutional (overall institutional ownership is 74.72 percent; large companies 75.78 percent and medium enterprises 65.93 percent).

As for testing the hypotheses, the authors tested the data as a whole, as a cluster of large-sized companies, and as a cluster of medium-sized companies. Table 2 shows the results of the hypothesis testing.

Variable	**Coeficient**	**t-statistic**	**P-*Value***	**H1-4**	**Notes**
S(Constant)	0.008	0.140	0.889		
Institutional Ownership	-0.032	-1.663	0.101	H_3	Rejected
Independent Commissioners	-0.087	-3.087	0.003	H_1	Accepted
Number of Audit Committee Meetings	-0.002	-2.761	0.007	H_2	Accepted
Audit Quality	-0.001	-0.130	0.897	H_4	Rejected
Company Age	-0.003	-0.340	0.735		
Company Size	-0.002	-0.554	0.581		
Value F	3.514				
Sig. F	0.004				
F Table	2.237				
R Square	0.239				
Adjusted R Square	0.171				
Significance 5% or 0, 1-4					
Large-Sized Companies					
(Constant)	0.029	0.461	0.647		
Institutional Ownership	-0.032	-1.555	0.125	H_3	Rejected
Independent Commissioners	-0.094	-3.219	0.002	H_1	Accepted
Number of Audit Committee Meetings	-0.002	-2.519	0.015	H_2	Accepted
Audit Quality	-0.001	-0.136	0.892	H_4	Rejected
Company Age	-0.001	-0.130	0.897		
Company Size	-0.003	-0.904	0.370		
Value F	3.506				

Sig. F	0.005				
F Table	2.368				
R Square	0.263				
Adjusted R Square	0.188				
Significance 5% or 0.05 H1-4: Initial Hypothesis 1-4					
Medium-Sized Companies					
(Constant)	0.815	0.231	0.684		
Institutional Ownership	-0.013	-0.059	0.957	H_3	Rejected
Independent Commissioners	-0.026	-0.539	0.954	H_1	Rejected
Number of Audit Committee Meetings	-0.001	-0.913	0.964	H_2	Rejected
Audit Quality	-0.056	-1.914	0.628	H_4	Rejected
Company Age	-0.032	-0.471	0.720		
Company Size	-0.055	-0.475	0.718		
F Value	0.344				
Sig. F	0.861				
F Table	19.296				
R Square	0.674				
Adjusted R Square	0.284				
Significance 5% or 0,05 H_{1-4}: Initial Hypothesis 1-4					

Table 2. Hypothesis Testing for all Companies, Large-Sized, and Medium-Scale

The results of the testing of the hypotheses can be seen in Table 2. Tests on the whole sample and large-sized company cluster yield the same results, and hypotheses 1 and 2 are accepted, while hypotheses 3 and 4 are rejected. The tests on the medium-sized company cluster shows that no hypothesis is accepted. It is possible that this was due to the relatively small sample (only 8 companies).

Independent commissioners and audit committees are elements of governance that can improve earnings quality. Both the overall test and the cluster of large-sized companies' independent commissioners have a positive effect on earnings quality. According to the National Committee on Governance Policy, the board of commissioners—as an organ of the company—is collectively responsible for supervising and providing advice to the directors, and ensuring that the company implements GCG. In practice, members of the board of commissioners must be professional and have integrity, as well as ensure that the directors pay attention to the interests of all stakeholders. The supervisory and advisory functions of the board of commissioners include preventive actions, up to temporary dismissal. In carrying out its supervisory function, the board of commissioners may appoint members who are independent, that is to say, members who come from outside the company.

The number of independent commissioners must be capable of ensuring that the oversight mechanism runs effectively and in accordance with the laws and regulations. The Financial Services Authority (OJK) determines this amount in Regulation No.57/POJK.04/2007, article 19, which stipulates that the percentage of independent commissioners must be at least 30 percent of the total number of members of the board of commissioners. This requirement will give boost to commissioners so they can stay independent and prioritizing their professional job (Khatib et al., 2021). Moreover, a study conducted by Solikhah et al. (2022) stated that bigger firm tend to have more effective independent commissioner and impacting earnings quality. That is because bigger firm will have bigger public exposure as opposed to smaller ones. Bigger exposure means bigger pressure for firm to stay true for their community and increase the need for better internal monitoring function.

Those reason also justified why this study cannot explain the role of independent commissioners for medium-sized companies. Additionally, it is possible to not finding the significant effects due to relatively small number of companies in the sample. The average composition of the boards of commissioners of medium-sized companies in the manufacturing sector complies with the regulations for a minimum number of independent commissioners, namely 43.37 percent (i.e. more than 30 percent), but it should be considered that this proportion is not the main factor in the effectiveness of control over management, but rather the capability integrity, and competence of the independent members of the commissioners themselves.

Another possibility is that the placement of independent commissioners on the board of commissioners is only done in order to fulfill formal requirements, meaning that the presence of independent commissioners is only a formality in medium-sized companies. This is supported by the Asian Development Bank survey cited in Boediono (2005) which states that the strong control by the founders and majority share owners of companies causes the boards of commissioners to be not independent and the oversight function that is their responsibility is not able to run effectively. This lack of oversight can lead to fraud in the company which has an impact in terms of the low quality of earnings reported by the company (Nanang & Tanusdjaja, 2019).

The results for the role of the audit committee are in accordance with predictions, both for the overall tests and those for large-sized companies. The audit committee lends support to the board of commissioners and acts as a party that protects outsiders from fraud on the part of the management of companies (Cristianto, 2018); it also enhances financial credibility (Cohen et al., 2022). This is not the case for medium-sized companies; indeed, studies indicate otherwise. The number of meetings held by the audit committees is possibly only to meet the minimum requirements set by the OJK, namely four times a year (quarterly). Lower firm size also linked to higher centralization resulting in imbalance power between firm's decision-maker and other firm's mechanisms (López-Fernández & García-Álvarez, 2023). Given lower exposure of medium sized-firm compared to bigger one, this can lead to reduced effectivity of internal monitoring function on earnings quality (Solikhah et al., 2022)

What might be happening in the field is that the meetings held by the audit committee do not focus on issues related to internal control, risk, the process of preparing financial reports, and discussing good governance practices (Effendi & Daljono, 2013; Sadjiarto et al., 2019). Audit committees that hold meetings frequently may not necessarily be able to reach decisions that can suppress earnings management practices; therefore, the quality of the meetings held is what needs to be considered.

The degree of institutional ownership cannot increase the quality of earnings. Firms analyzed in this study have a relatively large number of institutional ownership structures; this can be seen in the average institutional ownership of 74.72 percent, which reflects the fact that institutional investors generally have great control over companies.

Institutional owners only act as transient investors or temporary owners of companies who only focus on short-term profits (Kristanti & Hendratno, 2017). This causes institutional shareholders to be less aware of their rights and responsibilities in paying attention to the survival of the company which is reflected in the quality of the earnings generated.

The responsibility of institutional owners as controlling shareholders (i.e. where they own more than 50 percent) is limited to maintaining accountability and inter-company relations, so institutional owners do not have direct influence over company management. It was found that institutional ownership does not lead to an increase in earnings quality in either large-sized or medium-sized companies.

The quality of the earnings generated by a company is not affected by the quality of the audit provided by the Big 4 or non-Big 4 auditors. There are several possibilities that still need to be questioned regarding the audit quality provided by the Big 4 and non-Big 4 Public Accounting Firms, in his findings, states that audit quality characteristics in ASEAN countries, including Indonesia, can still be compromised by various factors.

Not all Big 4 auditors have the same audit quality when measured by the cost of capital in each country. The lack of regulations governing auditor independence also makes it difficult to measure the effect of audit quality on earnings quality. The lack of auditor independence can lead to reduced auditor objectivity in decision-making. Low-independence problem is triggered by many factors, one of them is regulation (Castillo-Merino et al., 2020). Auditors are seen as being unable to detect earnings management practices because management utilizes the accrual accounting system, which deter the power of accountant since regulation gives permission to do so (Kono & Yuyetta, 2013; Nurintiati & Purwanto, 2017).

The influence of company size and company age were found to be not significant. This means that the quality of earnings is not determined by the length of time the company has been established and the size of the company. All tests—whether with the entire sample, or the clusters of large-sized or medium-sized companies—yielded the same results.

CONCLUSION

This study has examined the role of good corporate governance and earnings quality. Earnings quality was calculated using a sample of companies from the 2011-2018 period, while the hypotheses were tested using the annual reports from 2019. This study has found that independent commissioners and audit committees exhibit the role of good governance which can increase earnings quality, while the opposite was found with institutional ownership and audit quality. In medium-sized companies, the governance structures and mechanisms fail to support earnings quality improvement.

This research has two important implications. First, this research found that independence monitoring governance mechanisms is the key factors to ensure company's earnings quality. Regulators (in this case OJK and IDX) can improve independence monitoring role by regulation. The criteria should not only cover the minimum member but also other criteria such as minimum disclosure and reporting. Second, investors should be wary about the lack of corporate governance mechanisms effect on firm's earnings quality on medium-sized firm. They should not rely solely on corporate governance disclosure to believe in firm's reported earnings.

This study has two limitations: (1) the number of samples is still small due to a lack of completeness of the financial data (less than 7 years) owned by companies in the manufacturing sector; and (2) the number of medium-sized companies in the sample is relatively small (only eight) compared to large-sized companies (of which there were 66).

Given the limitations of this study, suggestions for further research are: (1) increasing the number of companies from other sectors in the samples, and (2) using indicators other than the number of employees determined by the Organization for Economic Co-operation and Development (OECD) in classifying company size; for example, using the measurement of total assets according to the National Standardization Agency, company size according to the Financial Services Authority Regulation Number 53/POJK.04/2017, or Law No.20 of 2008 concerning Small, Micro and Medium Enterprises.

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