

THE MODERATING ROLE OF INSTITUTIONAL OWNERSHIP ON THE DETERMINANTS OF EARNINGS QUALITY: EVIDENCE FROM EMERGING MARKET FIRMS IN INDONESIA

O PAPEL MODERADOR DA PROPRIEDADE INSTITUCIONAL NOS DETERMINANTES DA QUALIDADE DOS LUCROS: EVIDÊNCIAS DE EMPRESAS DE MERCADOS EMERGENTES NA INDONÉSIA

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Abstract

This study examines the determinants of earnings quality in Indonesian listed firms, with a focus on the moderating role of institutional ownership. Using panel data from 133 firms from 2022 to 2024, the research employs the Random Effects Model (REM) estimated using Generalized Least Squares (GLS). The findings reveal that only firm size has a significant and positive effect on earnings quality, indicating that larger firms tend to report more reliable and transparent financial information. In contrast, leverage, profitability, and institutional ownership, both as direct and moderating variables, do not significantly influence earnings quality. These results suggest that firm scale, rather than financial structure or ownership characteristics, is the primary driver of reporting quality in Indonesia's emerging market. Institutional investors, although dominant, appear to play a passive monitoring role, limiting their governance effectiveness. The

Resumo

Este estudo investiga os determinantes da qualidade dos lucros em empresas listadas na Indonésia, com ênfase no papel moderador da propriedade institucional. Utilizando dados em painel de 133 empresas no período de 2022 a 2024, a pesquisa emprega o Modelo de Efeitos Aleatórios (REM) estimado por Mínimos Quadrados Generalizados (GLS). Os resultados revelam que apenas o tamanho da empresa tem um efeito positivo e significativo sobre a qualidade dos lucros, indicando que empresas maiores tendem a apresentar informações financeiras mais confiáveis e transparentes. Em contraste, a alavancagem, a rentabilidade e a propriedade institucional — tanto de forma direta quanto moderada — não influenciam significativamente a qualidade dos lucros. Esses resultados sugerem que a escala da empresa, e não sua estrutura financeira ou características de propriedade, é o principal fator que determina a



study contributes to agency theory by demonstrating that governance mechanisms in emerging economies are driven by size rather than ownership. Practical implications are provided for regulators and investors seeking to enhance the credibility of financial reporting.

Keywords: Earnings Quality. Leverage. Firm Size. Profitability. Institutional Ownership. Indonesia.

qualidade das demonstrações financeiras no mercado emergente indonésio. Embora dominantes, os investidores institucionais parecem exercer um papel de monitoramento passivo, limitando sua eficácia na governança. O estudo contribui para a teoria da agência ao demonstrar que os mecanismos de governança em economias emergentes permanecem orientados pelo tamanho e não pela estrutura de propriedade.

Palavras-chave: Qualidade dos Lucros. Alavancagem. Tamanho da Empresa. Rentabilidade. Propriedade Institucional. Indonésia.

1 INTRODUCTION

Earnings quality has become a central issue in accounting and financial reporting, particularly in emerging markets where information asymmetry and agency conflicts are often more pronounced than in developed economies (Saji, 2022). Earnings quality refers to the extent to which reported earnings faithfully represent the firm's underlying economic performance, free from manipulation, and helpful in predicting future cash flows (Alardah, 2023). Key attributes such as discretionary accruals, persistence, timeliness, and value relevance are commonly used to assess earnings quality. When earnings are of high quality, investors and other stakeholders can make more informed decisions because the financial statements accurately reflect the firm's actual financial condition and operational performance (Auliyah & Agit, 2024).

However, despite the theoretical importance of earnings quality, its realisation varies significantly across institutional settings. In emerging markets, structural characteristics such as weaker regulatory frameworks, less stringent enforcement, and more concentrated ownership structures exacerbate problems of information asymmetry and agency conflict. Information asymmetry allows managers, who possess superior internal knowledge, to engage in earnings management or conceal poor performance from outside investors. Empirical evidence from Bhattacharya *et al.*, (2013) indicates that poor earnings quality is associated with increased information asymmetry, particularly in environments with weak reporting standards. Similarly, agency conflicts between shareholders and managers often motivate opportunistic behaviour, such as manipulating

earnings to meet debt covenants or market expectations. The presence of institutional investors with effective monitoring capabilities can mitigate these behaviours, thereby improving the credibility of financial reports and protecting shareholders' interests (Bhattacharya *et al.*, 2013).

Several empirical studies have examined the relationship between ownership structure and earnings quality in Indonesia. Arafah & Arfan (2025) examined basic industry and chemical companies listed on the Indonesia Stock Exchange from 2021 to 2023 and found that institutional ownership has a positive and significant effect on earnings quality, suggesting that institutional shareholders can exert effective monitoring over management, thereby enhancing the reliability of financial reporting. Similarly, Kristiawan (2024) documented that ownership concentration, often associated with institutional holdings, has a positive impact on earnings quality, reinforcing the argument that ownership structure plays a crucial role in enhancing the transparency and accountability of corporate reporting in Indonesia.

Other scholars have focused on earnings management as the inverse proxy for earnings quality. Saftiana *et al.* (2014) investigated the effect of governance quality, institutional ownership, firm size, and leverage on earnings management. They found that leverage significantly influences earnings management, while institutional ownership and firm size were not statistically significant when tested individually, though they had a joint effect when considered simultaneously. This finding suggests that the role of institutional ownership may be more pronounced when examined as an interaction term with other financial and governance variables, thereby motivating the use of a moderating approach in this study.

Recent evidence from other emerging markets further supports the moderating role of institutional ownership. Al-Duais *et al.* (2022) utilised data from Malaysia and found that institutional and family ownership reduce real earnings management, thereby enhancing earnings quality. Mehrani *et al.* (2017), in a study of the Tehran Stock Exchange, distinguished between active and passive institutional owners and found that active institutional investors have a more substantial positive impact on earnings quality. Similarly, Alrobai *et al.* (2025) provided evidence from Egypt showing that firm attributes such as leverage, profitability, and size, together with ownership structure, jointly shape earnings quality, with some relationships exhibiting non-linear effects. These findings underscore the importance of examining the moderating role of

institutional ownership in the emerging market context, where variations in corporate governance systems, ownership concentration, and regulatory enforcement may yield distinct outcomes.

This study aims to investigate the factors influencing earnings quality, including leverage, firm size, and profitability. Leverage is often linked to a firm's financial risk and managerial incentives, potentially motivating earnings management to meet debt covenants or reduce perceived risk, thereby lowering earnings quality. Firm size is generally associated with greater visibility, stronger internal controls, and stricter regulatory scrutiny, which may enhance earnings quality. Similarly, profitable firms tend to face less pressure to manipulate earnings, resulting in higher earnings quality. However, these relationships may not be uniform across different institutional settings, especially in emerging markets where governance structures and ownership patterns differ significantly from those in developed countries.

Institutional ownership has been widely recognized as a key governance mechanism capable of monitoring managerial behaviour and improving financial reporting quality. Institutional investors typically possess the expertise, resources, and incentives to oversee management, thereby reducing agency problems and constraining opportunistic reporting practices. Nevertheless, empirical findings on the moderating role of institutional ownership remain mixed, and little is known about how institutional ownership influences the relationship between leverage, firm size, profitability, and earnings quality in emerging market contexts. In Indonesia, where concentrated ownership and family-controlled firms are prevalent, the monitoring effectiveness of institutional ownership may be particularly salient.

Overall, this study contributes to the growing body of literature on corporate governance and financial reporting in emerging markets by clarifying the moderating effect of institutional ownership on the determinants of earnings quality. By focusing on Indonesian listed firms, this research not only provides country-specific insights but also offers comparative implications for other emerging economies seeking to strengthen transparency, investor protection, and reporting credibility.

The novelty of this study lies in its focus on the moderating role of institutional ownership in explaining the determinants of earnings quality within Indonesia's emerging capital market, using recent panel data and a comprehensive model that integrates financial and governance variables. Unlike prior research that essentially treated

institutional ownership as a direct determinant, this study explicitly tests its moderating function and provides comparative evidence aligned with agency theory. The study contributes to the literature by extending empirical evidence from emerging economies, refining theoretical understanding of institutional monitoring effectiveness, and offering practical implications for regulators and investors concerned with improving financial reporting transparency in Southeast Asia.

2 THEORETICAL FRAMEWORK

2.1 Agency theory and earnings quality

Agency theory explains the relationship between principals (shareholders) and agents (managers) when the latter are entrusted with decision-making authority. According to Jensen & Meckling (1976), managers may act in their own interests rather than in those of shareholders, creating *agency conflicts*. In this context, earnings quality becomes a proxy for the degree of alignment between managerial behaviour and shareholder value. High-quality earnings reflect transparent, reliable, and faithfully represented performance, whereas low-quality earnings suggest opportunistic reporting, income smoothing, or concealment of poor performance (Healy & Wahlen, 1999).

In markets with weak governance, limited enforcement, and concentrated ownership, such as those found in Indonesia, agency conflicts tend to be more severe. Managers often exploit discretion in accounting standards to manipulate accruals or manage earnings to meet targets. As P. Dechow *et al.* (2010) argue, the quality of reported earnings depends not only on managerial intent but also on the institutional context in which firms operate. Hence, strong governance mechanisms, including active institutional monitoring, are crucial for mitigating opportunistic reporting and ensuring that earnings accurately reflect a firm's actual performance.

Institutional investors, as informed and resourceful shareholders, can mitigate agency problems through active monitoring and control. Studies such as Arafah & Arfan (2025) and Mehrani *et al.* (2017) demonstrate that institutional ownership enhances earnings quality by reducing managerial opportunism. However, the Indonesian market, with its mix of concentrated family ownership and evolving governance practices, presents unique challenges. Although institutional investors dominate ownership, their

monitoring effectiveness varies across industries, making Indonesia a valuable context for investigating how agency relationships shape earnings quality.

2.2 Leverage and earnings quality

Leverage reflects a firm's dependence on debt financing and can influence managerial behaviour in two opposing ways (Pahala *et al.*, 2025). On the one hand, debt can discipline managers by imposing external monitoring from creditors. On the other hand, high leverage can pressure managers to manipulate earnings to avoid covenant breaches or signal financial stability (Jelinek, 2007). In emerging markets, where creditor enforcement is weak, leverage often serves as a source of financial stress rather than discipline, leading to reduced earnings quality.

Empirical evidence suggests a negative relationship between leverage and earnings quality, particularly in markets with less stringent regulatory oversight. Van Khanh & Hung (2020) Found that highly leveraged firms tend to engage in accrual-based earnings management to maintain target ratios. Similarly, DeFond & Jiambalvo (1994) revealed that managers manipulate accruals to avoid violating loan agreements. In Indonesia, where bank-based financing dominates, such pressures may be more pronounced as firms rely heavily on debt relationships and face strong incentives to overstate profitability.

Therefore, leverage is expected to have a negative effect on earnings quality in Indonesian firms. However, this relationship can be moderated by governance mechanisms, especially institutional ownership. When institutional investors effectively monitor management, they can counterbalance debt-induced incentives for manipulation, reducing the adverse impact of leverage on reporting quality.

H1: Leverage has a negative effect on earnings quality.

2.3 Firm size and earnings quality

Firm size is often viewed as a proxy for a company's visibility, operational complexity, and regulatory exposure. Larger firms face greater scrutiny from investors, regulators, and auditors, which motivates them to maintain transparent reporting practices (Watts & Zimmerman, 1990). They also tend to possess more robust internal controls and

resources to ensure compliance with accounting standards, which collectively enhance earnings quality.

From an informational perspective, large firms are followed more closely by analysts and the media, reducing information asymmetry and limiting the scope for earnings manipulation. (P. Dechow *et al.*, 2010; Francis *et al.*, 2005) found that large firms produce higher-quality earnings due to better disclosure practices and corporate governance structures. In Indonesia, studies by Kristiawan (2024) and Saftiana *et al.* (2014) confirm that firm size is positively associated with earnings quality, reflecting stronger governance and adherence to OJK and IFRS-based reporting standards among larger listed firms.

However, firm size alone does not guarantee transparency. When ownership is concentrated or institutional monitoring is weak, large firms may still manipulate earnings to maintain favourable market perceptions. Thus, the presence of institutional investors may amplify the positive influence of firm size on earnings quality by ensuring that managerial actions remain aligned with the integrity of disclosure.
H2: Firm size has a positive effect on earnings quality.

2.4 Profitability and earnings quality

Profitability indicates a firm's ability to generate income and reflects its operational success (Pahala *et al.*, 2025). According to agency theory, profitable firms are under less pressure to manipulate earnings, as their performance already meets investor expectations (Watts & Zimmerman, 1990). Conversely, unprofitable firms may have more substantial incentives to manage earnings to conceal poor results. Therefore, profitability is expected to enhance earnings quality by reducing the motivation for opportunistic reporting.

Empirical findings reinforce this relationship. P. M. Dechow & Dichev (2002) and Francis *et al.* (2008) demonstrated that firms with consistent profitability exhibit more persistent and predictable earnings, signalling stronger earnings quality. In Indonesia, Saftiana *et al.* (2014) found that profitability positively influences earnings quality through better accrual management and reduced manipulation incentives. Profitable firms, especially those monitored by institutional investors, are more likely to maintain transparent financial reporting to sustain their market reputation.

However, the relationship between profitability and earnings quality can be contingent upon the strength of governance. Institutional investors can reinforce this link by ensuring that high profits are reported accurately rather than exaggerated. In contrast, in weakly monitored firms, profitability may not translate into credible reporting. Hence, institutional ownership can enhance the credibility of profitability signals and strengthen their positive impact on earnings quality.

H3: Profitability has a positive effect on earnings quality.

2.5 Institutional ownership as a moderating variable

Institutional ownership refers to the shareholdings held by professional investors, such as mutual funds, insurance companies, and pension funds, which possess the expertise and incentives to monitor management effectively. Agency theory posits that such investors reduce information asymmetry and managerial opportunism through active oversight (Shleifer & Vishny, 1997). As a result, institutional ownership is often associated with enhanced financial reporting credibility and improved earnings quality (Bushman & Smith, 2001).

Empirical studies provide mixed but insightful evidence. Arafah & Arfan (2025) and Mehrani *et al.* (2017) showed that institutional investors enhance earnings quality through active monitoring. In contrast, Fithria *et al.* (2021) found that institutional ownership can sometimes have an adverse moderating effect in Indonesia's banking sector, suggesting that institutional investors may be more passive or profit-oriented than governance-driven. These findings suggest that the effectiveness of institutional ownership depends on the level of activism, ownership concentration, and the institutional environment.

Given Indonesia's dominance of institutional investors, which hold over 70% of listed shares, understanding their moderating influence is critical. Institutional ownership is expected to mitigate the negative impact of leverage on earnings quality and to strengthen the positive relationships between firm size, profitability, and earnings quality. Thus, this study examines whether institutional investors serve as effective governance agents capable of enhancing financial transparency and reporting quality in Indonesia's emerging capital market.

H4: Institutional ownership moderates the relationship between leverage and earnings quality.

H5: Institutional ownership moderates the relationship between firm size and earnings quality.

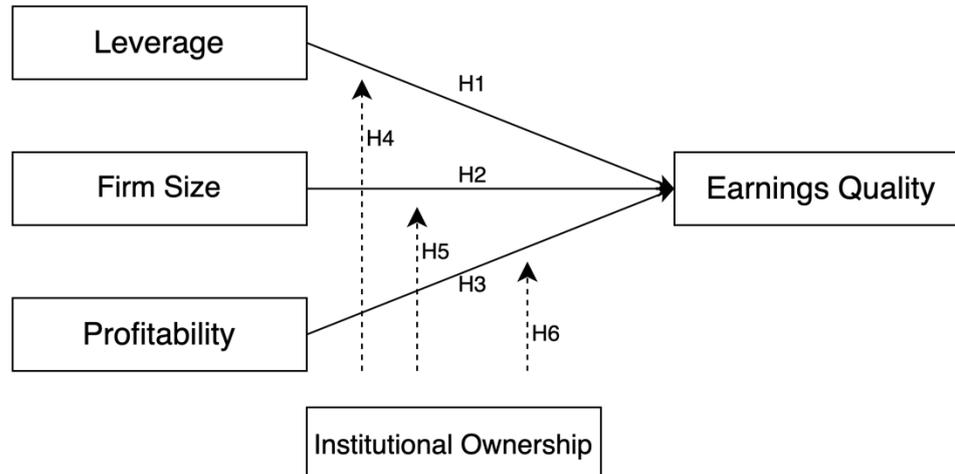
H6: Institutional ownership moderates the relationship between profitability and earnings quality.

2.6 Conceptual framework

Based on the theoretical foundation and several previous studies, this study examines the moderating role of institutional ownership on the determinants of earnings quality, such as leverage, firm size, and profitability. So the framework of thinking used is as follows:

Figure 1

Conceptual Framework



3 METHODOLOGY

This study utilises an unbalanced panel dataset comprising 133 companies observed over the period from 2022 to 2024. The sample was determined using the purposive sampling method. Companies were selected based on specific criteria relevant to the research objectives. The sampling criteria are as follows: (1) the company must

have been listed on the Indonesia Stock Exchange (IDX) before December 31, 2021; (2) the company must have published financial statements in Indonesian Rupiah from 2022 to 2024; and (3) the company must provide complete data required for measuring the research variables.

Based on the results of the model selection tests, the Chow test produced a probability value of 0.000, which is smaller than 0.05, indicating that the Fixed Effect Model (FEM) was initially suitable. However, the Hausman test yielded a probability value of 0.8929, which is greater than 0.05, suggesting that the Random Effects Model (REM) is more appropriate. This finding was further supported by the Lagrange Multiplier (LM) test, where the Breusch-Pagan probability value of 0.0410 (less than 0.05) confirmed that the REM is the best-fitting model for this study.

Since the chosen model is the Random Effect Model (REM), classical assumption tests such as normality, multicollinearity, heteroskedasticity, and autocorrelation are not strictly required. In the REM, individual and time variations are treated as random components of the error term, and estimation is conducted using the Generalised Least Squares (GLS) method. The GLS estimator automatically corrects for heteroskedasticity and autocorrelation in the error structure, ensuring unbiased and efficient parameter estimation (Baltagi & Baltagi, 2008; Gujarati, 2009).

The regression estimation of the Random Effect Model is expressed as follows:

$$EQ_{i,t} = \alpha + \beta_1 LEV_{i,t} + \beta_2 FS_{i,t} + \beta_3 PROF_{i,t} + \beta_4 LEV_{i,t} IO_{i,t} + \beta_5 FS_{i,t} IO_{i,t} + \beta_6 PROF_{i,t} IO_{i,t} + \varepsilon_{i,t} \quad (1)$$

Information:

EQ : Earnings Quality

LEV : Leverage

FS : Firm Size

PROF : Profitability

IO : Institutional Ownership

Table 1*Operational definition of variables*

| Number | Variable Name | Definition | Measurement Method |
|--------|---|---|--|
| 1 | Earnings Quality with earnings predictability indicator | Earnings predictability is defined as a measure of earnings quality based on the ability of earnings to predict future earnings. | Standard deviation of net income. A large standard deviation indicates low earnings quality. |
| 2 | Leverage | Comparison between funds obtained from external sources with funds provided by the company's owners. | $\frac{Total\ Debt_{i,t}}{Total\ Equity_{i,t}}$ |
| 3 | Firm Size | The size of a company is seen from the total resources owned by the business entity or company. | $Ln (Total\ Assets)_{i,t}$ |
| 4 | Profitability | The company's ability to generate profits so as to increase the company's value for shareholders and is also an indicator of good company management. | $\frac{Net\ Income_{i,t}}{Average\ Total\ Assets_{i,t}}$ |
| 5 | Institutional Ownership | Ownership of company capital by owners in the form of companies/institutions/ other institutions | The total value of shares owned by a company/ institution/or other institution divided by the total of the company's outstanding shares. |

4 RESULTS AND DISCUSSIONS**4.1 Model estimation and selection**

Based on the results of the model specification tests, the most appropriate estimation model for this study is the Random Effects Model (REM). The Chow test on Table 2 yielded a probability value of $0.000 < 0.05$, indicating that the Fixed Effect Model (FEM) is superior to the Common Effect Model. However, the Hausman test on Table 3 resulted in a probability value of $0.8929 > 0.05$, suggesting that the Random Effects Model is preferable to the Fixed Effects Model. This conclusion was reinforced by the Lagrange Multiplier (LM) test on Table 4 with a probability of $0.0410 < 0.05$, confirming the selection of the REM as the most efficient estimator. Following Baltagi & Baltagi (2008) and Gujarati (2009), REM estimation via Generalized Least Squares (GLS) automatically corrects for heteroskedasticity and autocorrelation, rendering further classical assumption testing unnecessary.

Table 2*Chow Test*

| Redundant Fixed Effects Tests Test cross-section fixed effects | | | |
|---|------------|----------|--------|
| Effects Test | Statistic | d.f. | Prob. |
| Cross-section F | 1.761552 | (132,65) | 0.0059 |
| Cross-section Chi-square | 310.306591 | 132 | 0.0000 |

Source: Authors, 2025

Table 3*Hausman Test*

| Correlated Random Effects - Hausman Test Test cross-section random effects | | | |
|---|----------------------|--------------|--------|
| Test Summary | Chi-Sq. Statistic | Chi-Sq. d.f. | Prob. |
| Cross-section random | 2.273985 | 6 | 0.8929 |

Source: Authors, 2025

Table 4*Lagrange Multiplier (LM) Test*

| Lagrange Multiplier Tests for Random Effects Null hypotheses: No effects Alternative hypotheses: Two-sided (Breusch-Pagan) and one-sided (all others) alternatives | | | |
|---|----------------------|----------------------|----------------------|
| | Test Hypothesis | | |
| | Cross-section | Time | Both |
| Breusch-Pagan | 4.176962 (0.0410) | 0.885356 (0.3467) | 5.062317 (0.0245) |

Source: Authors, 2025

4.2 Hypothesis testing results

The partial test (t-test) on Table 5 indicates that only firm size significantly affects earnings quality, with a *p-value* of 0.0063 (< 0.05). Other variables, such as leverage, profitability, and the moderating interactions, exhibited *p-values* greater than 0.05, implying no significant partial influence.

The F-test on Table 6 yielded a probability value of 0.003259 (< 0.05), suggesting that, collectively, all independent variables have a simultaneous influence on earnings quality. However, according to Table 7, the coefficient of determination (Adjusted R²) of 0.0662 (6.6%) indicates that the independent variables explain only a small portion of the variation in earnings quality. In comparison, the remaining 93.4% is influenced by other unobserved factors, such as governance structure, audit quality, or external regulatory pressures.

Table 5

Hypothesis Test

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|--|-------------|------------|-------------|--------|
| C | 1.47E+14 | 8.92E+13 | 1.645034 | 0.1016 |
| Leverage | -1.54E+13 | 2.80E+13 | -0.548874 | 0.5837 |
| Firm Size | 9.01E+12 | 3.26E+12 | 2.763586 | 0.0063 |
| Profitability | 2.40E+14 | 2.05E+14 | 1.171573 | 0.2428 |
| Leverage_ Institutional Ownership | 4.89E+13 | 3.94E+13 | 1.240754 | 0.2162 |
| Firm Size_ Institutional Ownership | -3.33E+11 | 1.18E+12 | -0.281949 | 0.7783 |
| Profitability_ Institutional Ownership | -4.82E+13 | 2.70E+14 | -0.178734 | 0.8583 |

Source: Authors, 2025

Table 6

F-test

| | |
|--------------------|-----------|
| R-squared | 0.093816 |
| Adjusted R-squared | 0.066216 |
| S.E. of regression | 5.94E+13 |
| Sum squared resid | 6.94E+29 |
| Log likelihood | -6755.676 |
| F-statistic | 3.399182 |
| Prob(F-statistic) | 0.003259 |

Source: Authors, 2025

Table 7

Coefficient of Determination

| | |
|--------------------|-----------|
| R-squared | 0.093816 |
| Adjusted R-squared | 0.066216 |
| S.E. of regression | 5.94E+13 |
| Sum squared resid | 6.94E+29 |
| Log likelihood | -6755.676 |
| F-statistic | 3.399182 |
| Prob(F-statistic) | 0.003259 |

Source: Authors, 2025

4.3 Leverage and earnings quality

The regression results show that leverage does not significantly influence earnings quality. The level of debt financing among Indonesian listed firms does not create sufficient financial discipline to affect reporting transparency. In theory, debt can serve as an external monitoring mechanism that constrains managerial opportunism (Widodo & Lima, 2025). However, in Indonesia, credit markets are dominated by relationship-based lending, where lenders often maintain long-term ties with borrowers. Consequently, debt contracts are less likely to enforce strict financial covenants or accounting-based restrictions, reducing the disciplinary role of leverage in improving earnings quality.

Furthermore, in emerging markets, high leverage can also lead to information manipulation rather than transparency Alsaadi (2025) and Nguyen *et al.* (2021). When financial distress risk increases, managers may use accrual adjustments or earnings management to maintain the appearance of solvency (Park *et al.*, 2021; Viana Jr *et al.*, 2022). Studies by Dyreng *et al.* (2022) confirm that highly leveraged firms are more likely to engage in income-increasing accruals to avoid covenant violations. The same pattern may occur in Indonesia, where financial institutions rely heavily on collateral rather than earnings quality to assess creditworthiness, weakening the monitoring power of creditors over managerial reporting practices.

This finding implies that leverage in Indonesia reflects financial dependence rather than governance discipline. In the absence of effective creditor oversight, managers can retain discretion over earnings presentation without fear of debt-related sanctions. The weak link between leverage and earnings quality thus reinforces the idea that external debt monitoring mechanisms remain underdeveloped in Indonesia's financial system. Consequently, improving transparency requires not just financial leverage but the enhancement of monitoring quality through stronger creditor governance, enforcement, and accounting-based covenants.

4.4 Firm size and earnings quality

Firm size has a positive and significant impact on earnings quality, confirming that larger firms tend to exhibit more transparent and credible financial reporting. This

result aligns with the *political cost hypothesis* (Watts & Zimmerman, 1990), which posits that large firms face greater public scrutiny, regulatory oversight, and reputational pressures. Consequently, they have more substantial incentives to avoid aggressive earnings manipulation, as such behaviour could attract negative attention from stakeholders, regulators (OJK), and the media. The presence of advanced internal controls and more established audit committees in large firms further contributes to higher earnings reliability.

From an information asymmetry perspective, larger firms have more extensive disclosure requirements and greater analyst coverage, which reduces the information gap between management and investors. P. Dechow *et al.* (2010); Francis *et al.* (2005) demonstrated that firm size enhances accrual quality and reporting transparency due to improved governance infrastructure. In Indonesia, firms included in the LQ45 index or with multinational linkages are more likely to comply with IFRS-based financial reporting and OJK disclosure guidelines (Sukesti *et al.*, 2022). These firms typically engage reputable external auditors and maintain audit committees with professional expertise, which enhances both compliance and credibility.

This finding underscores that firm size operates as a proxy for governance quality in Indonesia's corporate environment. Since institutional ownership and other governance mechanisms appear less effective, external visibility becomes a more powerful driver of earnings transparency. Large firms' exposure to market and regulatory pressures substitutes for weak institutional oversight. Therefore, policymakers should leverage disclosure incentives for mid-sized firms to replicate these transparency standards, thereby enhancing the overall quality of financial reporting in Indonesia's emerging capital market.

4.4 Profitability and earnings quality

The analysis reveals that profitability does not significantly affect earnings quality. Although profitability theoretically reduces the incentive for manipulation—since successful firms have less need to distort performance—this result suggests that in Indonesia, even profitable firms may engage in earnings management. One plausible explanation is the tendency for *income smoothing*, where managers adjust earnings to present a stable trend over time. This behaviour is consistent with the argument of P. M.

Dechow & Dichev (2002) that managers use accrual discretion to reduce earnings volatility, particularly in uncertain economic environments.

Moreover, in emerging markets such as Indonesia, profitability is often used as a performance signal to attract investors and creditors. Managers of profitable firms may therefore seek to sustain or exaggerate profitability through discretionary accounting practices to maintain market confidence. Studies by Alrobai *et al.* (2025) and Saftiana *et al.* (2014) have documented similar patterns in other developing economies, where profitability does not guarantee transparent reporting. Thus, while profitability reflects operational efficiency, it may not necessarily correspond to truthful financial representation when governance mechanisms are weak, or investor protection is limited.

The absence of a significant profitability effect underscores the complex nature of managerial incentives in Indonesia's market context. It suggests that managerial motivations extend beyond actual performance toward maintaining reputation and market expectations. This finding highlights the need to strengthen monitoring systems and audit quality to ensure that reported profitability aligns with economic reality. Profit-based performance evaluation alone may be insufficient to assess financial integrity unless supported by robust governance and disclosure standards.

4.5 Moderating role of institutional ownership

The moderating effect of institutional ownership on the relationships between leverage, firm size, profitability, and earnings quality is found to be insignificant. It indicates that institutional investors in Indonesia have not yet functioned as effective governance agents capable of constraining managerial opportunism. Although institutional investors control most listed shares (over 70%), many adopt passive investment strategies, focusing on short-term returns rather than active engagement in corporate governance. As a result, their presence alone does not guarantee enhanced transparency or reporting integrity.

Several structural factors may explain this limited moderating influence. Indonesia's ownership landscape remains dominated by family-controlled and conglomerate-affiliated firms, where institutional investors often hold minority stakes. This concentrated ownership structure restricts the ability of institutional shareholders to exert influence over management decisions. In addition, weak enforcement of shareholder

rights and limited activism among domestic institutions reduce the effectiveness of institutional monitoring. Similar findings by Cornett *et al.* (2007) and Mehrani *et al.* (2017) show that only *active* institutional investors contribute meaningfully to improving earnings quality, while passive investors tend to accept managerial reporting at face value.

This finding highlights the institutional weakness of corporate governance in Indonesia, where monitoring mechanisms are present but not fully operational. While institutional ownership theoretically enhances earnings credibility, its impact depends on activism, ownership concentration, and investor protection. To strengthen this governance mechanism, regulatory bodies such as OJK should promote institutional investor stewardship codes, encouraging greater engagement in voting, disclosure review, and audit oversight. Such measures could transform institutional ownership from a nominal governance feature into an active driver of transparency and accountability.

5 CONCLUSION

This study examined the determinants of earnings quality among Indonesian listed firms, focusing on leverage, firm size, profitability, and the moderating role of institutional ownership. The empirical results, based on panel data analysis using the Random Effects Model, reveal that only firm size has a significant positive effect on earnings quality. It indicates that larger firms tend to produce higher-quality earnings due to stronger governance, greater regulatory scrutiny, and higher public visibility. Conversely, leverage, profitability, and institutional ownership, including their moderating effects, were found to be insignificant.

These findings suggest that in Indonesia's emerging market, corporate transparency is more influenced by firm scale than by financial structure or ownership characteristics. The weak moderating role of institutional ownership suggests that institutional investors have not yet effectively functioned as governance agents capable of mitigating agency problems. It highlights a limitation in Indonesia's governance landscape, where ownership concentration and passive monitoring hinder the effectiveness of institutional oversight in enhancing the credibility of financial reporting.

For regulators such as the OJK and IDX, the results underscore the need to promote more active institutional monitoring through stewardship codes and enhanced enforcement of disclosure. For firms, especially smaller ones, strengthening internal

control and audit mechanisms is essential to enhance earnings reliability. Future research should further differentiate between active and passive institutional investors and explore how audit quality or board characteristics interact with firm size in shaping earnings quality across emerging markets.

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Both authors contributed equally to the development of this article.

Data availability

All datasets relevant to this study's findings are fully available within the article.

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