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The Role of Corporate Governance in Moderating the Effects of Tax Efficiency, Profitability, and Investment Opportunities on Earnings Quality

Eka Muhammad Muqorrobien
Faculty of Economics and Business, Universitas Trisakti, Jakarta, Indonesia

Dedy Ahmadi Rambe
Faculty of Economics and Business, Universitas Trisakti, Jakarta, Indonesia

Jessica Jia Xu
Bond Business School, Bond University, Queensland, Australia

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ABSTRACT: This research is conducted to find out the effect of Tax Retention Rate, Profitability, and Investment Opportunity Set on earnings quality and to examine the Corporate Governance variable as the moderating variable. The theoretical basis used in this research is agency theory and signaling theory. Based on those theories, good corporate governance will reduce the principal-agent conflict of interest and send a positive signal to investors through its credible financial reporting. This study employs a quantitative approach with secondary data that consists of the financial reports of LQ45 index companies listed in the Indonesian Stock Exchange (IDX) from 2020 to 2024. The data were analysed using Moderated Regression Analysis (MRA). The results indicate that Tax Retention Rate has a negative and significant effect on earnings quality. Furthermore, the moderating analysis reveals that Corporate Governance can moderate the relationship between Tax Retention Rate and earnings quality by weakening the negative impact of tax retention policies. These findings highlight that corporate governance mechanisms are more effective in controlling policies directly associated with earnings management incentives, particularly tax-related decisions.

KEYWORDS: Tax Retention Rate, Profitability, Investment Opportunity Set, Corporate Governance, Earnings Quality.

INTRODUCTION

In an increasingly intricate and competitive business landscape, stakeholders necessitate transparent, pertinent, and dependable information to facilitate economic decision-making processes. Financial statements constitute one of the principal sources of such information, as they are generated in accordance with universally accepted accounting principles and standards. These reports function as a pivotal tool for evaluating an organization's financial standing and performance, which are anticipated to reflect the overall state of the enterprise with precision and comprehensiveness. The information revealed in financial statements assumes a vital role for investors when determining whether to maintain, augment, or reallocate their investments to alternative enterprises (Kristy et al., 2024). Furthermore, corporate earnings exert a substantial influence on capital market dynamics and fluctuations in stock prices (Putra & Widanaputra, 2021).

A multitude of instances pertaining to the manipulation of financial statements underscores the existence of deficiencies in corporate governance and oversight mechanisms at both international and domestic echelons. Such malpractices are generally orchestrated to project an excessively advantageous portrayal of a corporation's fiscal performance to stakeholders and the general populace. For example, Merck was documented to have acknowledged fictitious revenues that had yet to be realized (The Guardian, 2002). WorldCom partook in extensive manipulation by capitalizing on network expenditures and modifying specific accounts to artificially enhance reported earnings (Investopedia, n.d.). In a similar vein, Xerox faced sanctions from the U.S. Securities and Exchange Commission (SEC) for hastening revenue recognition, which culminated in an anomalous escalation in pre-tax income (U.S. SEC, 2002).

Comparable incidents have also occurred in Indonesia. PT Hanson International Tbk was penalized by the Financial Services Authority (OJK) for improper revenue recognition related to land sales, which led to overstated earnings (OJK, 2020). A similar case involved PT Garuda Indonesia (Persero) Tbk, which misrecognized revenue from long-term contracts in 2018 (MHI Journal, 2021). In addition, PT Waskita Karya (Persero) Tbk was suspected of reporting profits that were inconsistent with its actual cash flow conditions (Liputan6, 2023), while PT eFishery Innovations Tbk was allegedly found to have prepared dual versions of its financial statements to conceal its true financial condition (DetikFinance, 2025). These cases underscore the importance of financial reporting integrity and effective regulatory oversight in maintaining public confidence in the capital market.

According to agency theory, managers, acting as agents, may prioritize their personal interests over those of shareholders, who act as principals (Jensen & Meckling, 2019). Within the context of financial reporting, such conflicts may motivate managers to engage in earnings management practices in order to portray financial performance more favorably. Prior studies, including Saleh et al. (2020) and Lee (2022), indicate that effective monitoring mechanisms can reduce managerial incentives to manipulate earnings. This finding is consistent with Putra & Widanaputra (2021), who demonstrate that stronger corporate governance can mitigate information asymmetry and enhance earnings quality. However, mixed empirical results suggest the need to incorporate controlling variables, such as corporate governance, to better explain the relationship between agency conflicts and earnings quality.

Signaling theory further explains how management communicates firm prospects to external parties through financial reporting. Firms may use earnings information or financial policy disclosures as signals to convey stability and growth potential to investors (Spence, 1973; Erawati & Sari, 2021). Nevertheless, existing literature reveals inconsistent findings. Chen et al. (2025) argue that reported earnings often fail to fully represent a firm's actual economic condition due to information asymmetry, whereas Ayagi & Salisu (2023) emphasize that signal credibility is essential to prevent financial information from becoming misleading. Accordingly, signaling theory is relevant for explaining how financial indicators such as profitability, the Tax Retention Rate, and the Investment Opportunity Set are utilized by management as communication tools in capital markets.

The Tax Retention Rate (TRR) reflects the effectiveness of managerial efforts in managing tax expenses in a compliant and efficient manner (Susilawati et al., 2024). A higher TRR indicates a greater ability to retain net income after tax; however, aggressive tax planning may increase future tax risks and reduce earnings quality if such practices distort the firm's true economic performance (Chen et al., 2024). Prior studies report divergent findings. Anggirda et al. (2022) suggest that tax efficiency enhances shareholder welfare and improves earnings quality, a conclusion supported by Susilawati et al. (2024), who find that tax planning positively affects earnings quality. In contrast, Minanari & Asmara (2023) as well as Arizona et al. (2017) report that aggressive tax planning negatively influences earnings quality. These inconsistencies indicate that the relationship between tax efficiency and earnings quality is not linear and may depend on corporate governance practices and the level of information transparency.

Profitability is commonly used as a fundamental indicator of a firm's ability to generate earnings from its assets. Firms with higher profitability are generally perceived as having superior financial performance and are expected to send positive signals to investors (Kristy et al., 2024). Nevertheless, empirical evidence regarding the effect of profitability on earnings quality remains inconclusive. Studies by Pangesti et al. (2023), Nandika & Sunarto (2022), and Luas et al. (2021) report a positive relationship, suggesting that higher profitability reflects managerial efficiency and earnings stability. Conversely, Kartika & Handayani (2023), Ilma & Subardjo (2023), Erawati & Sari (2021), and Indriana & Handayani (2021) argue that high profitability may increase incentives for accrual manipulation as managers attempt to sustain a favorable market image, thereby reducing earnings quality. Meanwhile, Rimawan & Muniarty (2023) and Wijayanti & Subardjo (2019) find no significant effect of profitability on earnings quality. These inconsistencies highlight the importance of re-examining the role of profitability while considering corporate governance as a behavioral control mechanism.

The Investment Opportunity Set (IOS) represents a firm's future investment prospects that are expected to generate returns exceeding the cost of capital (Mulyati et al., 2021). A high IOS signals strong growth potential and is generally viewed positively by investors. However, prior research also reports mixed results. Kristy et al. (2024), Gultom & Sitorus (2023), and Pandaya et al. (2023) find that IOS positively affects earnings quality, as firms with strong growth prospects tend to maintain credible financial reporting. In contrast, Yusmaniarti et al. (2023) and Rahmawati & Hidayat (2020) suggest that firms with high IOS are more prone to earnings management in order to meet market expectations, thereby negatively affect earnings quality. Ilma & Subardjo (2023) further report no significant relationship between IOS and earnings quality. To address this research gap, the present study incorporates corporate governance as a moderating variable to explain how monitoring mechanisms may influence the relationship between IOS and earnings quality.

Although numerous studies have examined the relationship between financial factors and earnings quality, inconsistent findings indicate the presence of unresolved research gaps. Many prior studies focus primarily on the direct effects of financial variables-such as the Tax Retention Rate, profitability, and IOS-without adequately considering the role of corporate governance as a mechanism for controlling managerial behavior and safeguarding the credibility of financial information. Therefore, this study introduces corporate governance as a moderating variable to bridge these inconsistencies and provide a more comprehensive explanation of earnings quality determinants.

This study integrates agency theory and signaling theory to explain how corporate governance strengthens the relationship between financial variables and earnings quality. Effective governance mechanisms can constrain managerial opportunism, enhance accountability, and ensure the integrity of financial reporting, thereby improving earnings quality. This argument is supported by Solikhah et al. (2022), who find that firms with strong corporate governance practices tend to report higher-quality earnings due to effective internal monitoring that limits earnings management. Furthermore, this study differs from prior research by focusing on firms included in the LQ45 index, which are expected to better represent the overall conditions of the Indonesian capital market compared to studies relying on sector-specific samples.

The present study seeks to examine whether the Tax Retention Rate, profitability, and the Investment Opportunity Set influence corporate earnings quality, and whether corporate governance is capable of moderating these relationships. By addressing these issues, this research aims to provide a more comprehensive understanding of earnings quality determinants from both financial and governance perspectives.

Specifically, the objectives of this study are to analyze the effects of the Tax Retention Rate, profitability, and the Investment Opportunity Set on earnings quality, as well as to assess the moderating role of corporate governance. The findings are expected to contribute theoretically to the accounting literature and practically to corporate decision-making by enhancing transparency and the quality of financial reporting.

Moreover, the results are expected to assist investors in gaining deeper insights into firms' financial performance, thereby enabling more rational and informed investment decisions based on reliable earnings information. This study is also anticipated to serve as an evaluative reference for improving the implementation of corporate governance practices, which are essential for ensuring that reported earnings accurately reflect a firm's true economic performance.

Corresponding Author: Eka Muhammad Muqorrobien

LITERATURE REVIEW

Agency theory

Agency theory explains the contractual relationship between company owners (principals) and managers (agents), in which principals delegate decision-making authority to agents to manage the firm in order to maximize shareholder value (Jensen & Meckling, 2019; Davidson et al., 2004). This delegation, however, creates the potential for conflicts of interest, as managers do not always act in alignment with shareholders' objectives. Managers may pursue personal goals that conflict with shareholder interests, such as manipulating reported earnings to present financial performance that appears more favorable than the firm's actual economic condition (Saleh et al., 2020; Jensen & Meckling, 2019).

Agency theory further emphasizes managers' incentives to engage in earnings management due to information asymmetry, as managers typically possess more comprehensive knowledge of a firm's internal operations than shareholders. This imbalance provides managers with opportunities to manipulate earnings to meet market expectations or to secure personal benefits, such as performance-based compensation. As a result, information asymmetry may undermine the credibility of financial reporting and ultimately reduce earnings quality (Saraphat et al., 2025). The theory posits that stronger corporate governance mechanisms can reduce information asymmetry by enhancing monitoring and control over managerial actions, thereby improving the accuracy of financial statements and the quality of reported earnings (Tahir et al., 2023; Tran et al., 2020).

Within the context of this study, agency theory helps explain how corporate governance mechanisms can mitigate the negative effects of managerial policies on earnings quality. Improved governance practices can limit opportunistic behavior, enhance reporting reliability, and ensure that earnings more accurately reflect the firm's underlying economic performance. This relationship is particularly important for investors and stakeholders who rely on high-quality financial information when making economic decisions (Jamal-Eddine & Charba, 2025). Accordingly, this study examines the moderating role of corporate governance in the relationship between financial factors, namely the Tax Retention Rate, profitability, and the Investment Opportunity Set-and earnings quality.

Signaling Theory

Signaling theory describes how corporate management conveys internal information and assessments to external parties, particularly financial statement users, through signals that reflect the firm's condition and future prospects (Kristy et al., 2024). Originally introduced by Spence (1973) in the context of labor markets, the theory addresses situations characterized by information asymmetry between informed parties (insiders) and less informed parties (outsiders). In financial reporting, such asymmetry may incentivize managers to act opportunistically by concealing or altering information, resulting in financial statements that do not fully represent the firm's actual performance (Arif & Hikmah, 2023; Saleh et al., 2020).

Signaling theory emphasizes that financial statements function as a strategic communication mechanism through which management seeks to convey favorable perceptions to investors and creditors, thereby encouraging economic decisions that reflect confidence in the firm's performance and value (Erawati et al., 2023). Signaling theory is particularly relevant for explaining how financial variables, such as profitability and the Investment Opportunity Set (IOS), are employed by management as indicators of the firm's future prospects to external stakeholders.

This theory is closely related to the role of corporate governance in ensuring that the signals conveyed by management are credible and reliable. Strong governance practices can reduce the risk of misleading signals by enhancing transparency and accountability in financial reporting (Efunniyi et al., 2024). In this study, signaling theory is used to examine how factors such as profitability and IOS serve as signals to investors and how corporate governance may strengthen or weaken the effectiveness of these signals. This theoretical framework helps explain the relationship between financial factors and earnings quality, while also providing insights into how firms communicate their financial health to the market.

Earnings Quality

Earnings quality reflects the extent to which reported earnings are reliable, transparent, and representative of a firm's true economic performance (Saleh et al., 2020; Dechow et al., 2010). High-quality earnings are expected not only to capture current-period performance but also to serve as a reliable basis for predicting future performance and cash flows. Conversely, low earnings quality suggests that reported earnings fail to reflect economic reality and may mislead financial statement users.

Low earnings quality is often associated with the separation of ownership and control, where managers act as agents managing corporate resources on behalf of shareholders. This separation creates potential conflicts of interest, as managers may prioritize personal benefits over shareholder value (Kristy et al., 2024). Consistent with agency theory, information asymmetrical between managers and shareholders can encourage opportunistic behavior, including earnings manipulation, thereby reducing the credibility of financial reporting.

Poor earnings quality can have serious consequences for stakeholders, including suboptimal economic decisions, increased investment risk, and reduced firm value (Erawati et al., 2023). Therefore, identifying the factors that influence earnings quality is essential, particularly in the context of managerial oversight and the implementation of effective corporate governance mechanisms to ensure that reported earnings are both credible and economically meaningful.

Tax Retention Rate

Corporate tax payments directly reduce net income and, consequently, the amount of earnings available for dividend distribution. As a result, management often engages in tax planning strategies to legally minimize tax liabilities in order to increase after-tax income for dividends or reinvestment purposes (Anggirda et al., 2022). Effective tax planning not only enhances shareholder welfare but may also positively influence firm value from an investor perspective (Kovermann & Velte, 2019).

From a signaling perspective, tax planning may serve as a positive signal regarding managerial efficiency and financial stability. However, agency theory highlights potential conflicts of interest when tax-saving strategies are implemented without sufficient transparency. Aggressive tax planning may reduce the reliability of financial statements and impair earnings quality, particularly when such practices are driven by short-term managerial incentives rather than long-term firm sustainability.

Empirical evidence supports this concern. Minanari & Asmara (2023) and Arizona et al. (2017) find that excessive tax planning negatively affects the reliability of financial reporting. High levels of tax planning or elevated TRR values may therefore reduce earnings quality by distorting the true economic condition of the firm. Accordingly, this study proposes the following hypothesis:

H1: The Tax Retention Rate has a negative effect on earnings quality.

Profitability

Profitability measures a firm's efficiency in generating earnings from its asset base and reflects management's ability to utilize resources effectively to create shareholder value. A high level of profitability, commonly measured by Return on Assets (ROA), indicates that the firm is able to generate substantial earnings relative to its total assets (Erawati et al., 2023).From a signaling theory perspective, high profitability serves as a positive signal to investors and creditors regarding a firm's financial performance and future prospects.

Agency theory suggests that high profitability may indicate that management is acting in shareholders' interests by maximizing firm value without engaging in opportunistic behavior. In this context, reported earnings are more likely to reflect the firm's actual economic performance. Several studies support this view, finding a positive relationship between profitability and earnings quality (Pangesti et al., 2023; Nandika & Sunarto, 2022; Luas et al., 2021).

Based on this reasoning, higher profitability is expected to signal higher earnings quality. Accordingly, the second hypothesis is formulated as follows:

H2: Profitability has a positive effect on earnings quality.

Investment Opportunity Set

The Investment Opportunity Set (IOS) represents the range of future investment opportunities available to a firm that are expected to generate returns exceeding the cost of capital (Mulyati et al., 2021). Firms with a high IOS are generally perceived as having strong growth potential and are therefore more attractive to investors. However, such conditions may also create incentives for management to engage in earnings management in order to maintain a favorable growth image.

In line with signaling and agency theories, a high IOS may function as a signal that the firm is capable of exploiting profitable investment opportunities and achieving superior future performance. Empirical studies by Kristy et al. (2024), Gultom & Sitorus (2023), Mulyati et al. (2021), Indriana & Handayani (2021), and Pandaya et al. (2021) find that IOS positively affects earnings quality, as firms with strong growth prospects tend to maintain credible financial reporting practices.

Based on this argument, firms with higher IOS values are expected to report higher-quality earnings. Therefore, the following hypothesis is proposed:

H3: The Investment Opportunity Set has a positive effect on earnings quality.

Corporate Governance

The implementation of corporate governance practices is essential for building investor confidence and ensuring transparency in corporate operations (Susilawati et al., 2024). Corporate governance serves as a positive signal to stakeholders that management operates in an accountable and responsible manner, reducing information asymmetry and agency conflicts.

Corporate governance plays a moderating role by strengthening or weakening the relationship between financial factors and earnings quality. Winarsih et al. (2023) demonstrate that strong governance can moderate the relationship between profitability and earnings quality by monitoring managerial performance and limiting accrual manipulation. Similarly, Erawati et al. (2023) find that governance mechanisms can moderate the relationship between IOS and earnings quality by ensuring responsible investment decision-making.

Furthermore, Susilawati et al. (2024) report that strong corporate governance moderates the relationship between the Tax Retention Rate and earnings quality by promoting tax compliance and limiting excessive tax avoidance. Accordingly, effective governance mechanisms help maintain transparency, enhance managerial accountability, and balance the relationship between tax efficiency, profitability, and earnings quality. Based on this discussion, the following hypotheses are proposed:

H4: Corporate governance moderates the relationship between the Tax Retention Rate and earnings quality.

H5: Corporate governance moderates the relationship between profitability and earnings quality.

H6: Corporate governance moderates the relationship between the Investment Opportunity Set and earnings quality.

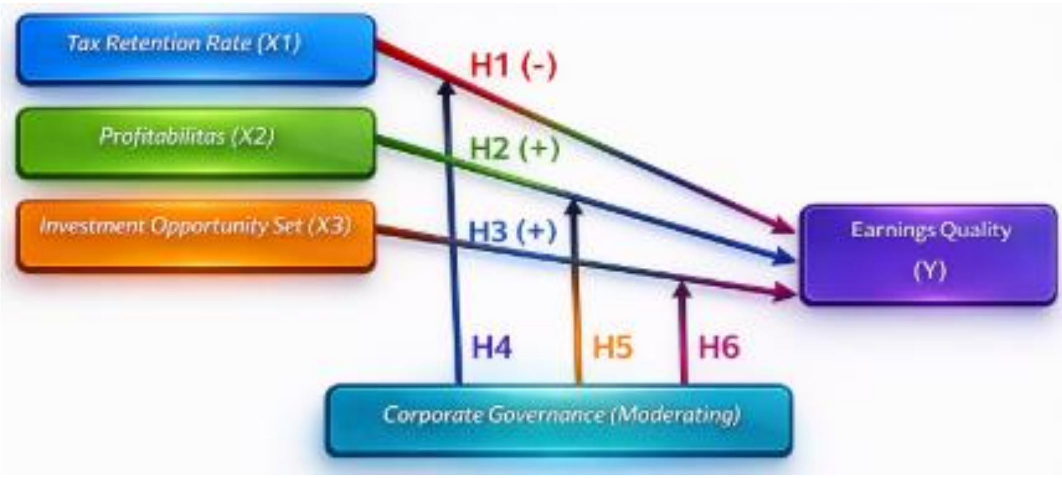

Figure 1: Research Theoretical Framework

MATERIALS AND METHODS

This study employs a causal-associative research design to analyze the relationships among the variables under investigation (Sugiyono, 2016). This approach is intended to examine the extent to which the independent variables influence earnings quality in companies listed on the Indonesia Stock Exchange (IDX). The study utilizes secondary data obtained from corporate financial statements, which are collected from the official website of the Indonesia Stock Exchange as well as from the respective corporate websites of the sampled firms.

The research population consists of companies included in the LQ45 index during the 2020-2024 period, totaling 60 firms. The selection of LQ45 companies is based on the consideration that these firms exhibit the highest levels of market capitalization and trading liquidity, thereby providing a representative overview of the overall conditions of the Indonesian capital market. Sample selection is conducted using a purposive sampling technique with the following criteria: firms consistently publish complete financial statements throughout the observation period, are not subject to trading suspension, do not report losses, and apply a fiscal year ending on December 31 (Ghozali, 2018).

Preliminary examination of the relationships among variables is performed using descriptive statistical analysis (Field, 2013). Data validity and reliability are subsequently assessed through classical assumption tests, including normality (Field, 2013), multicollinearity (Hair et al., 2019), heteroscedasticity, and autocorrelation tests (Wooldridge, 2010). Hypothesis testing is carried out using Moderated Regression Analysis (MRA).

Earnings quality

Earnings quality reflects a firm's ability to generate sustainable profits that accurately represent its actual financial performance (Susanti et al., 2021). Earnings quality deteriorates when financial statements are not prepared fairly or fail to reflect the firm's true economic condition, as such misstatements may create information bias and potentially mislead stakeholders in their decision-making processes. Higher earnings quality indicates that reported earnings are more reliable, transparent, and supported by real economic activities, thereby enhancing the credibility of financial information disclosed to users (Murniati et al., 2018).

In line with Erawati et al. (2023), earnings quality in this study is measured using the ratio of operating cash flows to earnings before interest and taxes (EBIT). This measurement captures the extent to which reported earnings are supported by actual cash flows generated from operating activities. The earnings quality ratio is calculated using the following formula:

EQ = Operating Cash Flow / Earnings Before Interest and Taxes (1)

Tax Retention Rate

The effectiveness of corporate tax management can be assessed using the Tax Retention Rate (TRR), which indicates the extent to which after-tax earnings are retained relative to pre-tax income. According to Robinson (2020), the tax retention level reported in financial statements reflects the efficiency of managerial tax planning strategies. A higher TRR suggests that the firm is more effective in managing its tax burden through appropriate tax planning practices.

Nevertheless, excessively high TRR values may also give rise to adverse consequences, as they can increase potential tax risks and future tax liabilities. Such conditions may ultimately impair earnings quality if aggressive tax planning practices distort the firm's true economic performance. Therefore, while TRR serves as an indicator of tax efficiency, it may simultaneously signal a trade-off between short-term tax savings and long-term earnings sustainability.

Following Susilawati et al. (2024), the Tax Retention Rate in this study is measured using the following formula:

TRR = Net Income After Tax / Earnings Before Interest and Taxes (2)

Profitability

Profitability represents an indicator used to assess a firm's ability to generate earnings from the utilization of its total assets. This variable is commonly measured using the Return on Assets (ROA) ratio, which compares net income after tax to total assets (Kartika et al., 2023). A higher ROA value indicates that the firm is able to manage its resources efficiently and effectively to generate profits, reflecting superior operational performance.

In line with Indriana & Handayani (2021), profitability in this study is measured using the following formula:

ROA = (Net Income After Tax) / Total Aset) x 100% (3)

Investment Opportunity Set

The Investment Opportunity Set (IOS) represents an indicator of a firm's future growth opportunities and investment potential. IOS can be measured using a price-based proxy by comparing the market value of equity to its book value (Gultom & Sitorus, 2023). Firms with higher IOS values are generally perceived as more attractive to investors, as they are considered to possess stronger growth prospects and greater potential to generate higher future earnings.

Accordingly, an increase in IOS is often associated with improved earnings quality, as firms with substantial investment opportunities tend to exercise greater caution in maintaining the credibility and transparency of their financial reporting. This prudence is driven by the need to preserve investor confidence and sustain access to capital markets.

Following Mulyati et al. (2021), IOS in this study is measured using the Market Value of Assets to Book Value of Assets (MVA/BVA) ratio, formulated as follows:

MVA/BVA atau IOS = (Number of Outstanding Shares × Closing Share Price) / (Total Equity) (4)

Corporate Governance

Effective corporate governance plays a crucial role in mitigating agency problems, reducing corporate costs, and enhancing firm value by aligning the interests of management with those of shareholders and other stakeholders through managerial ownership mechanisms (Zamzamir et al., 2021). Within the corporate governance framework, managerial ownership serves as an important governance mechanism to maintain managerial objectivity and prevent conflicts of interest between managers and shareholders.

A higher proportion of managerial ownership is expected to strengthen monitoring effectiveness, improve transparency and accountability, and reduce managerial opportunism. By aligning managerial incentives with firm performance, managerial ownership encourages management to act in the best interests of the firm, thereby improving the reliability of financial reporting and enhancing earnings quality.

Following Kartika et al. (2023), corporate governance in this study is measured using the proportion of managerial ownership, which is calculated using the following formula:

CG = (Number of Shares Owned by Management) / (Total Outsanding Shares) x 100% **(5)**

Moderating Regression Analysis (MRA)

Moderated Regression Analysis (MRA) is employed to examine whether the relationship between the independent variables and the dependent variable is contingent upon the presence of a moderating variable. Specifically, this method assesses the extent to which corporate governance moderates the effects of each independent variable on earnings quality. The regression model used in this study is specified as follows:

$$EQ= \alpha + \beta 1TRR + \beta 2ROA + \beta 3IOS + \beta 1(TRR*CG) + \beta 2ROA*CG + \beta 3IOS*CG + \epsilon \quad (6)$$

RESULTS

Descriptive Statistical Analysis

The earnings quality mean value of 1.691, which is relatively close to the minimum value, suggests that the sample firms, on average, exhibit relatively low earnings quality. Furthermore, the standard deviation of 4.881 indicates a substantial dispersion of data around the mean, implying a high degree of variability across firms and classifying the data as heterogeneous. The TRR mean value of 0.580 suggests that, on average, the sample firms demonstrate a moderate level of tax planning effectiveness. Furthermore, the standard deviation of 1.167 exceeds the mean value, indicating a substantial dispersion of TRR observations across firms. This finding suggests that the data are heterogeneous, reflecting varying tax management strategies among the sampled companies. The profitability mean value of 0.072 indicates a moderate level of profitability across the sample firms, implying that, on average, the companies generated relatively favorable net earnings. Furthermore, the standard deviation of 0.080 exceeds the mean value, indicating considerable variability in profitability levels among firms. This dispersion suggests that the profitability data are heterogeneous across the sample. The IOS mean value of 3.351, which is relatively close to the minimum value, indicates that, on average, the sampled firms exhibit relatively low levels of investment opportunities. Furthermore, the standard deviation of 7.731 substantially exceeds the mean value, indicating a high degree of dispersion across firms. This result suggests that the IOS data are heterogeneous, reflecting significant variation in growth prospects among the sampled companies. The corporate governance mea value of 0.003, which is close to the minimum value, suggests that, on average, the sampled firms exhibit relatively low levels of corporate governance as measured by managerial ownership. Furthermore, the standard deviation of 0.012 exceeds the mean value, indicating considerable variability across firms. This dispersion suggests that corporate governance data are heterogeneous.

Panel Data Regression Model Selection

Based on the results of the panel data regression model selection tests, it can be concluded that the Chow test (the cross-section chi-square probability value is 0.000) indicates the Fixed Effect Model (FEM) is more appropriate than the Common Effect Model (CEM). Furthermore, the Hausman test (the probability value for the cross-section random test is 0.9470) suggests that the Random Effect Model (REM) is more suitable than the Fixed Effect Model (FEM). In addition, the Lagrange Multiplier test (the Breusch-Pagan probability value (Both) is 0.000) confirms that the Random Effect Model (REM) outperforms the Common Effect Model (CEM).

Accordingly, the Random Effect Model (REM) is selected as the final panel data regression model in this study, as it is considered the most appropriate for explaining the relationships among the independent variables, the moderating variable, and the dependent variable. The use of REM allows for the efficient estimation of parameters while accounting for unobserved heterogeneity across firms, thereby enhancing the robustness and reliability of the empirical results.

RESULTS OF MODERATED PANEL DATA REGRESSION ANALYSIS

Table 1. Selected Random Effect Model (REM) as the Best Model

Variable	Coefficient	Probability (2 tailed)	Probability (1 tailed)
Constant	3,621	0,000	0,000
Tax Retention Rate (X1)	-3,638	0,000	0,000
Profitability (X2)	0,399	0,919	0,459
Investment Opportunity Set (X3)	0,015	0,741	0,370
Corporate Governance (M)	-71,010	0,294	0,147
Tax Retention Rate (X1) * Corporate Governance (M)	65,752	0,001	0,000
Profitability (X2) * Corporate Governance (M)	-82,025	0,709	0,354
Investment Opportunity Set (X3) * Corporate Governance (M)	30,515	0,467	0,233

Source: Processed data using EViews, 2025.

Based on Table 1, the estimation results of the Random Effect Model (REM), the moderated regression equation is formulated as follows:
EQ= 3,621 − 3,638 (Tax Retention Rate) + 0,399 (Profitability) + 0,015 (investment opportunity set) + 65,752 (TRR*CG) − 82,025 (Profitability*CG) + 30,515 (IOS*CG) + ϵ

Based on the moderate regression equation, the constant term and the coefficients of each variable indicate their respective effects on earnings quality. The constant term has a coefficient of 3.621, implying that when the Tax Retention Rate, profitability, and the Investment Opportunity Set are held constant, earnings quality increases by 3.621 units.

The coefficient of the Tax Retention Rate (X1) is −3.638, indicating that a one-unit increase in the Tax Retention Rate leads to a decrease in earnings quality of 3.638 units. The profitability variable (X2) has a positive coefficient of 0.399, suggesting that a one-unit increase in profitability is associated with an increase of 0.399 units in earnings quality. Similarly, the Investment Opportunity Set (X3) has a positive coefficient of 0.015, indicating that a one-unit increase in IOS results in a 0.015-unit increase in earnings quality.

With respect to the moderating role of corporate governance (M), the interaction term between the Tax Retention Rate and corporate governance (TRR × CG) has a positive coefficient of 65.752. This result indicates that corporate governance strengthens the relationship between the Tax Retention Rate and earnings quality by mitigating the negative effect of tax retention practices. In contrast, the interaction between profitability and corporate governance (Profitability × CG) has a negative coefficient of −82.025, indicating that higher levels of corporate governance weaken the relationship between profitability and earnings quality. Furthermore, the interaction between the Investment Opportunity Set and corporate governance (IOS × CG) yields a positive coefficient of 30.515, suggesting a strengthening effect; however, this interaction is not statistically significant.

Overall, the results indicate that corporate governance plays a significant moderating role only in the relationship between the Tax Retention Rate and earnings quality. In contrast, the interactions between corporate governance and profitability, as well as between corporate governance and the Investment Opportunity Set, do not exhibit statistically significant effects on earnings quality.

Hypothesis Testing

Coefficient of Determination

Based on the analysys, the adjusted R^2 value is 0.743, indicating that approximately 74.3% of the variation in earnings quality (Y) can be explained by the Tax Retention Rate (X1), profitability (X2), Investment Opportunity Set (X3), corporate governance (M), and the interaction terms between the independent variables and corporate governance (X1 × M, X2 × M, and X3 × M).

The remaining 25.7% of the variation in earnings quality is attributable to other factors not included in the regression model. These factors may involve firm-specific characteristics, macroeconomic conditions, or other governance and financial variables beyond the scope of this study. The relatively high adjusted R^2 value indicates that the moderated regression model demonstrates strong explanatory power and is considered adequate for explaining the relationships among the independent variables, the moderating variable, and earnings quality.

F-Test

Based on the test, the F-statistic value is 60.733 with a probability of 0.000, which is below the 5 percent significance level ($\alpha = 0.05$). This result indicates that the Tax Retention Rate (X1), profitability (X2), Investment Opportunity Set (X3), corporate governance (M), and the interaction terms between the independent variables and corporate governance (X1 × M, X2 × M, and X3 × M) jointly and significantly affect earnings quality (Y).

In other words, the results of the F-test confirm that all variables included in the moderated regression model collectively contribute to explaining variations in firms' earnings quality. This finding supports the overall validity and robustness of the regression model in capturing the combined effects of financial and governance-related factors on earnings quality.

t-Test

Table 2. t-test Results of the REM Model

Variabel	Hypothesized Direction	Coefficient	Probability (1 tailed)	Result
Constant	-	3,621	0,000	-
Tax Retention Rate (X1)	Negative	-3,638	0,000	H1 Accepted
Profitability (X2)	Positive	0,399	0,459	H2 Rejected
Investment Opportunity Set (X3)	Positive	0,015	0,370	H3 Rejected
Corporate Governance (M)	-	-71,010	0,147	
Tax Retention Rate (X1) * Corporate Governance (M)	Strengthening	65,752	0,000	H4 Accepted
Profitability (X2) * Corporate Governance (M)	Strengthening	-82,025	0,354	H5 Rejected
Investment Opportunity Set (X3) * Corporate Governance (M)	Strengthening	30,515	0,233	H6 Rejected

Source: Processed data using EViews, 2025.

Based on Table 2, The coefficient of the Tax Retention Rate (X1) variable is −3.638, indicating that an increase in the tax retention rate leads to a decrease in earnings quality (Y). The probability of 0.000 is lower than the 5 percent significance level. Therefore, the null hypothesis is rejected and H1 is accepted. This result confirms that the Tax Retention Rate has a negative and significant effect on earnings quality. The profitability variable (X2) has a coefficient value of 0.399, suggesting that higher profitability tends to increase earnings quality. However, the probability of 0.459 exceeds the 5 percent significance level. Thus, the null hypothesis is accepted and H2 is rejected. This finding indicates that profitability does not have a significant effect on earnings quality. The Investment Opportunity Set (X3) shows a coefficient of 0.015, implying a positive relationship with earnings quality. Nevertheless, the probability value of 0.370 is greater than 0.05. Accordingly, the null hypothesis is accepted and H3 is rejected, indicating that the Investment Opportunity Set does not significantly influence earnings quality. The corporate governance variable (M) has a coefficient of −71.010, suggesting that an increase in corporate governance is associated with a decrease in earnings quality. However, as a moderating variable, corporate governance is classified as a pure moderator, meaning it does not directly affect earnings quality but operates through its interaction with independent variables. In this context, corporate governance does not have a direct significant impact on earnings quality but plays a role when interacting with certain explanatory variables, particularly the Tax Retention Rate.

The interaction between Tax Retention Rate and Corporate Governance (X1 × M) has a coefficient of 65.752, indicating that higher interaction values lead to an increase in earnings quality. The probability of 0.000 is below the 5 percent significance level. Therefore, the null hypothesis is rejected and H4 is accepted. This result demonstrates that corporate governance weakens the negative effect of the Tax Retention Rate on earnings quality.

The interaction between profitability and corporate governance (X2 × M) yields a coefficient of −82.025, suggesting a negative relationship with earnings quality. However, the probability value of 0.354 exceeds the significance threshold. Consequently, the null hypothesis is accepted and H5 is rejected, indicating that corporate governance does not significantly moderate the relationship between profitability and earnings quality.

The interaction between the Investment Opportunity Set and corporate governance (X3 × M) produces a coefficient of 30.515. Despite the positive coefficient, the probability value of 0.233 is greater than 0.05. Thus, the null hypothesis is accepted and H6 is rejected, implying that corporate governance does not significantly strengthen the relationship between the Investment Opportunity Set and earnings quality.

DISCUSSION

The Effect of Tax Retention Rate on Earnings Quality

One of the primary indicators used to evaluate firm performance is the company's ability to generate profits. Management performance in utilizing corporate resources is reflected in the level of profit achieved. Investors tend to place greater trust in firms that generate higher profits, as such firms are perceived to have stronger capabilities to sustain and expand their operations. Moreover, companies that demonstrate consistent earnings growth are viewed positively by investors because they are expected to deliver higher returns in the future (Zahirah & Hermanto, 2023).

However, an increase in earnings is generally accompanied by a higher tax burden, which reduces net income derived from managerial resource allocation. This condition may trigger conflicts of interest between management and shareholders, as explained by agency theory. To address this issue, management often engages in tax planning strategies aimed at legally minimizing tax expenses to increase net income available for dividend distribution or reinvestment (Anggirda et al., 2022).

Nevertheless, excessive tax planning motivated by management's desire to maintain superior performance may negatively affect earnings quality. Previous studies have indicated that aggressive tax planning practices can reduce the reliability of reported earnings (Arizona et al., 2017; Susilawati et al., 2024). The tension between the objective of maximizing profits and the effort to suppress tax expenses represents a critical agency conflict that may undermine the credibility of earnings as an indicator of firm performance.

The empirical results of this study demonstrate that the Tax Retention Rate has a negative and significant effect on earnings quality. This finding suggests that although tax planning plays an important role in enhancing corporate profitability, overly aggressive tax strategies may distort earnings quality. Management tends to exploit loopholes within tax regulations to achieve tax efficiency without violating legal provisions. However, increasingly stringent tax regulations restrict managerial flexibility in conducting efficient tax planning. As a result, excessive tax planning may reduce earnings quality by limiting the firm's capacity to distribute dividends to investors and by weakening the sustainability of reported earnings.

This finding is consistent with prior studies by Minanari & Asmara (2023) and Arizona et al. (2017), which emphasize that aggressive tax planning practices, while intended to maximize net income, may ultimately deteriorate earnings quality.

The Effect of Profitability on Earnings Quality

The empirical results indicate that profitability does not have a significant effect on earnings quality. Although the regression coefficient shows a positive direction, the relationship is not statistically significant. This finding suggests that profitability cannot be considered a primary determinant in explaining variations in firms' earnings quality.

These results imply that higher or lower levels of reported profits do not automatically reflect superior earnings quality (Erawati et al., 2023). High profitability may not necessarily be supported by strong operating cash flows or conservative financial reporting practices and, therefore, may fail to represent the firm's true economic condition. Consequently, earnings quality appears to be more strongly influenced by accounting policies, managerial integrity, and the transparency of financial reporting than by the magnitude of profits generated.

These findings are in line with research by Rimawan & Muniarty (2023), Erawati et al. (2023) and Wijayanti & Subardjo (2019) where high or low levels of profitability do not affect earnings quality. This study is inline with the view that profitability mainly reflects short-term financial performance, whereas earnings quality captures sustainability, reliability, and credibility of earnings over the long term. Accordingly, firms with high profitability levels may still engage in earnings management practices, particularly when effective internal control mechanisms are absent. These findings reinforce the argument that profitability alone is insufficient as an indicator of earnings quality and that a more comprehensive analytical approach is required to properly assess earnings quality.

The Effect of Investment Opportunity Set on Earnings Quality

A high Investment Opportunity Set (IOS) provides positive signals to shareholders, as it indicates greater potential for future returns. IOS offers shareholders insights into the firm's future investment alternatives and growth prospects (Gultom & Sitorus, 2022). For investors seeking higher returns, firms with high IOS are generally perceived as having superior earnings quality, making them more attractive investment targets. From a theoretical perspective, companies with substantial growth opportunities are expected to maintain higher earnings quality in order to preserve investor confidence and enhance corporate reputation.

In contrast, firms with a low IOS may be more inclined to engage in earnings management practices to present improved financial performance in response to market expectations. IOS reflects a firm's future growth prospects by considering its current asset base and potential investment opportunities (Yusmaniairti et al., 2023). Firms with a high IOS typically exhibit stronger financial conditions and tend to allocate earnings toward new investments or asset expansion to generate future cash flows, rather than distribute higher dividends. Companies with abundant investment opportunities are expected to strengthen their competitive advantage, thereby allowing reported earnings to more accurately reflect underlying economic performance.

However, the empirical results of this study indicate that IOS does not have a significant effect on earnings quality. This finding suggests that other factors may exert a more dominant influence on earnings quality or that certain conditions-such as managerial policies, accounting practices, or corporate governance mechanisms-limit the direct impact of IOS on earnings quality. Although high IOS theoretically reflects strong future growth potential, it does not necessarily translate into higher reported earnings quality.

These findings are consistent with the study by Ilma & Subardjo (2023), which also reports no significant relationship between IOS and earnings quality. Nevertheless, the results differ from those of Kristy et al. (2024), Erawati et al. (2023), and Gultom & Sitorus (2022), who document a positive and significant effect. Such inconsistencies in the empirical literature suggest the need for further research, particularly by incorporating Corporate Governance as a moderating variable to provide a more comprehensive explanation of the relationship between IOS and earnings quality.

Corporate Governance as a Moderator of the Relationship between Tax Retention Rate and Earnings Quality

The empirical findings indicate that corporate governance (CG) significantly moderates the relationship between the tax retention rate (TRR) and earnings quality (EQ). The interaction between TRR and CG is statistically significant, suggesting that effective corporate governance mechanisms are able to attenuate the adverse impact of tax retention policies on earnings quality. In other words, while a higher tax retention rate tends to exert downward pressure on earnings quality, the presence of strong monitoring and control systems can curb managerial incentives to engage in tax-driven earnings management.

This result is consistent with agency theory, which argues that effective oversight mechanisms reduce agency problems by aligning the interests of managers and shareholders (Jensen & Meckling, 1976). Strong governance structures limit managerial discretion in tax-related decision-making and reduce opportunities for opportunistic behavior that may compromise the credibility of reported earnings.

Moreover, these findings emphasize the role of corporate governance as a key control mechanism in managerial behavior, particularly in the formulation and implementation of tax policies. Adequate governance practices encourage managers to adopt more cautious and transparent tax planning strategies, thereby ensuring that reported earnings more accurately reflect the firm's underlying economic performance. Consequently, corporate governance plays a crucial role in safeguarding earnings reliability and quality when firms engage in tax planning activities, while simultaneously mitigating potential conflicts of interest between managers and shareholders.

Corporate Governance as a Moderator of the Relationship between Profitability and Earnings Quality

Based on the empirical results, corporate governance (CG) is not proven to moderate the relationship between profitability (X2) and earnings quality (EQ). This is reflected in the statistically insignificant interaction coefficient between profitability and corporate governance, indicating that the presence of governance mechanisms neither strengthens nor weakens the effect of profitability on earnings quality.

These findings suggest that higher profit levels do not automatically translate into superior earnings quality, regardless of whether firms operate under strong or weak governance structures. Profitability primarily reflects short-term financial performance, whereas earnings quality is associated with sustainability, reliability, and extent to which reported earnings represent the firm's true economic condition (Dechow et al., 2010; Francis et al., 2004).

In this context, corporate governance appears to be insufficient in constraining potential earnings reporting practices related to profitability. Earnings quality is more strongly influenced by accounting policies, the degree of conservatism, and the integrity of financial reporting rather than by the magnitude of profits generated. Consequently, even firms with relatively strong governance mechanisms may not necessarily exhibit higher earnings quality solely due to higher profitability.

Corporate Governance as a Moderator of the Relationship between Investment Opportunity Set and Earnings Quality

The empirical results indicate that corporate governance (CG) does not function as a moderating variable in the relationship between the investment opportunity set (IOS) and earnings quality (EQ). This conclusion is supported by the statistically insignificant interaction coefficient between IOS and CG, suggesting that corporate governance neither strengthens nor weakens the effect of investment opportunities on earnings quality.

These findings imply that the magnitude of a firm's growth opportunities does not directly determine the quality of reported earnings, regardless of whether the firm operates under strong or weak governance mechanisms. IOS primarily reflects long-term growth prospects and investment decisions, whereas earnings quality is associated with the reliability, sustainability, and extent to which reported earnings represent the firm's underlying economic condition (Dechow et al., 2010).

Accordingly, corporate governance appears to be less effective in controlling potential earnings reporting distortions related to investment opportunities. Earnings quality is more strongly influenced by accounting policies and financial reporting practices than by expectations for future growth embedded in the investment opportunity set.

Based on the overall results of the moderated regression analysis, it can be concluded that corporate governance acts as a moderating variable only in the relationship between the tax retention rate and earnings quality, exhibiting the characteristics of a pure moderator. In contrast, corporate governance is not proven to moderate the relationships between profitability or the investment opportunity set and earnings quality. These findings highlight that the effectiveness of corporate governance is more pronounced in controlling policies that directly encourage earnings management practices-particularly tax-related decisions-rather than operational performance or investment opportunity factors.

Corresponding Author: Eka Muhammad Muqorrobien

CONCLUSION

This study aims to examine the effects of the tax retention rate, profitability, and investment opportunity set on earnings quality, as well as to investigate the moderating role of corporate governance. The findings indicate that the tax retention rate has a negative and significant effect on earnings quality, whereas profitability and the investment opportunity set do not exhibit significant influences. These results suggest that tax-related policies play a more dominant role in determining earnings quality than profitability performance and growth opportunities, as taxation policies are directly associated with managerial incentives in earnings management and financial reporting decisions.

The moderating analysis further reveals that corporate governance is able to moderate the relationship between the tax retention rate and earnings quality by mitigating the negative impact of tax retention policies. However, corporate governance is not found to moderate the relationship between profitability or the investment opportunity set and earnings quality. This finding emphasizes that corporate governance mechanisms are more effective in controlling policies that directly encourage earnings management practices-particularly those related to tax planning-than in influencing operational performance or growth expectations.

From an implication perspective, this study highlights the importance of implementing strong corporate governance mechanisms to maintain earnings quality, especially in the context of corporate tax decision-making. Effective governance functions as a monitoring mechanism that limits managerial opportunistic behavior, thereby ensuring that reported earnings more accurately reflect the firm's underlying economic conditions.

Nevertheless, this study is subject to several limitations, including the use of specific indicators to measure earnings quality and corporate governance, as well as constraints related to the observation period and sample size. Future research is encouraged to employ alternative measurement proxies, extend the observation period, and incorporate additional variables that may affect earnings quality-such as audit quality, ownership structure, and risk management practices-to develop a more comprehensive understanding of the determinants of earnings quality.

PLAGIARISM STATEMENT

The authors declare that this manuscript is original, has not been published previously, and is not under consideration for publication elsewhere. All sources used in this study have been properly cited in accordance with academic standards.

CONFLICT OF INTEREST

The authors declare that there is no conflict of interest associated with this research and the publication of this article.

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TABLES AND FIGURES

Table 1. Selected Random Effect Model (REM) as the Best Model
Table 2. t-test Results of the REM Model
Figure 1: Research Theoretical Framework

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