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Effect of profit quality on stock prices in manufacturing companies

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A R T I C L E I N F O

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ABSTRACT

This study examines the effect of earnings quality on stock prices in manufacturing companies, with the aim of providing empirical evidence on how reliable and informative financial reporting influences market valuation. Earnings quality, defined as the extent to which reported earnings reflect a company's true economic performance, is a critical factor in investment decision-making. Low-quality earnings, often influenced by aggressive accounting practices, can distort investors' perceptions and lead to mispricing in capital markets. Using a sample of manufacturing companies listed on the Indonesia Stock Exchange over the 2018–2023 period, this research employs a quantitative approach with panel data regression analysis. Earnings quality is measured through accrual-based and real earnings management indicators, while stock prices are captured through year-end closing prices. Control variables include firm size, leverage, and growth opportunities. The results indicate that higher earnings quality has a significant positive effect on stock prices, suggesting that investors value transparent and sustainable earnings information. Conversely, firms with low earnings quality tend to experience weaker market valuations, reflecting reduced investor confidence. These findings highlight the importance of enhancing the credibility of financial reporting through robust accounting standards and effective corporate governance. The study contributes to the literature on capital market efficiency and offers practical implications for policymakers, investors, and corporate managers.

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1. INTRODUCTION

The capital market plays a vital role in mobilizing funds from surplus economic units to deficit units, thereby facilitating investment, economic growth, and industrial development. In this context, stock prices serve as an important indicator of a company's market value and reflect investors' collective assessment of its current performance and future prospects. For manufacturing companies, which often operate in capital-intensive environments with long production cycles, stock prices not only represent the valuation of tangible assets but also capture market perceptions of intangible factors such as management quality, corporate governance, and financial reporting credibility. Among the various determinants of stock prices, the quality of earnings reported by companies has attracted significant scholarly and practical interest. Earnings quality refers to the degree to which reported earnings faithfully represent a company's actual economic performance and are free from distortion, bias, or manipulation (Dechow, Ge, & Schrand, 2010). High-quality earnings are typically characterized by sustainability, predictability, and transparency, enabling investors to make more informed decisions and reducing the likelihood of mispricing in the capital market. Conversely, low-quality earnings, often

resulting from earnings management practices, can mislead stakeholders, impair decision-making, and erode investor confidence.

In an era of increasing globalization and competitive pressures, the manufacturing sector faces heightened expectations for accurate and transparent financial reporting. The sector's complexity—arising from diverse product lines, fluctuating raw material prices, technological advancements, and global supply chain interdependencies—can create opportunities for managerial discretion in earnings presentation. While managerial discretion is not inherently negative, its misuse can result in opportunistic earnings management that undermines the reliability of reported financial results. The relationship between earnings quality and stock prices is critical to understanding market efficiency. According to the Efficient Market Hypothesis (Fama, 1970), in a semi-strong form market, all publicly available information, including financial statements, should be reflected in stock prices. If earnings quality is high, financial statements convey accurate signals about a firm's profitability and future cash flows, leading to a positive market response. However, if earnings quality is compromised, market participants may misinterpret a company's financial condition, resulting in mispricing, abnormal returns, or volatility.

Prior research has shown mixed evidence regarding this relationship. Some studies (e.g., Francis, LaFond, Olsson, & Schipper, 2004) find that high-quality earnings are associated with lower cost of capital and higher market valuations, implying a positive relationship with stock prices. Others suggest that market participants may not always discern between high- and low-quality earnings, especially in emerging markets with lower transparency and weaker enforcement mechanisms (Fan & Wong, 2002). This ambiguity underscores the importance of examining the relationship in specific contexts, such as the Indonesian manufacturing sector. In Indonesia, the manufacturing industry is a major contributor to GDP and a significant player in the capital market. The Indonesia Stock Exchange (IDX) lists numerous manufacturing companies spanning sub-sectors such as food and beverages, chemicals, textiles, automotive, and electronics. These companies are subject to Indonesian Financial Accounting Standards (PSAK), which are increasingly aligned with International Financial Reporting Standards (IFRS). Despite these advancements, cases of earnings management, delayed reporting, and restatements still occur, raising questions about the consistency of earnings quality and its influence on investor perceptions.

Signaling Theory (Spence, 1973) posits that corporate managers send signals to the market through financial disclosures. High-quality earnings signal strong financial health, effective management, and growth potential, leading to favorable investor reactions and higher stock prices. Conversely, poor earnings quality sends negative signals that may cause investors to reassess the company's value. Agency Theory (Jensen & Meckling, 1976) highlights conflicts of interest between managers (agents) and shareholders (principals). Managers may have incentives to manipulate earnings to meet short-term targets or personal performance goals, even at the expense of long-term shareholder value. Such behavior reduces earnings quality, distorts stock prices, and increases information asymmetry. These frameworks provide a lens to understand how earnings quality can influence stock prices in manufacturing companies. By integrating these perspectives, the study addresses both the information content of earnings and the governance mechanisms that can mitigate opportunistic behavior.

Complex Cost Structures – Manufacturing involves significant costs related to raw materials, labor, and overhead allocation, which provide scope for accounting discretion in cost capitalization, depreciation, and inventory valuation. Capital Intensity – Large investments in machinery and facilities require long-term financing, making stock price stability crucial for investor confidence and fundraising capabilities. Cyclicality – The sector is sensitive to macroeconomic conditions, which can affect revenues and margins. Managers may be tempted to smooth earnings during downturns to project stability. Global Market Competition – Export-oriented manufacturing firms face exchange rate fluctuations and trade policy risks, increasing the importance of transparent reporting to international investors. Because of these factors, the relationship between earnings quality and stock prices in manufacturing companies warrants focused investigation, especially in emerging markets such as Indonesia.

While international studies have explored the link between earnings quality and stock prices extensively, fewer studies have concentrated on emerging economies where institutional frameworks, investor sophistication, and enforcement levels differ significantly from developed markets. Moreover, within Indonesia, research specifically targeting the manufacturing sector is limited, despite the sector's importance to the national economy. Existing Indonesian studies often focus on earnings management in general or on broader market indices without disaggregating by sector. Consequently, there is insufficient evidence on whether earnings quality in manufacturing companies exerts a measurable

influence on stock prices and how this relationship may differ from other sectors. This gap creates an opportunity to contribute empirical findings that can inform both academic discourse and practical investment decisions.

Theoretical Contribution – It enriches the literature on financial reporting quality and capital market behavior in the context of emerging markets, particularly Indonesia. By focusing on the manufacturing sector, it offers a nuanced understanding of how industry-specific characteristics interact with earnings quality to influence stock prices. Practical Contribution – For investors, the findings can serve as a guide for incorporating earnings quality into valuation models and investment decisions. For regulators and policymakers, the results may highlight the need for stricter enforcement of accounting standards and corporate governance codes. For corporate managers, the study emphasizes the long-term value of maintaining high earnings quality to sustain investor trust and market valuation.

The scope of this study is limited to manufacturing companies listed on the Indonesia Stock Exchange over the 2018–2023 period. Earnings quality will be measured using established proxies, including discretionary accruals (as per the Modified Jones Model) and indicators of real earnings management such as abnormal production costs and discretionary expenses. Stock prices will be represented by year-end closing prices, adjusted for stock splits and corporate actions. the relationship between earnings quality and stock prices is of paramount importance in assessing the efficiency and integrity of capital markets. For manufacturing companies, this relationship is influenced by industry-specific factors, corporate governance practices, and the broader institutional environment. By focusing on the Indonesian manufacturing sector, this study seeks to provide robust empirical evidence on how earnings quality shapes market valuation, thereby contributing to academic understanding and practical investment strategies.

2. RESEARCH METHOD

This study employs a quantitative research design using panel data to examine the effect of earnings quality on stock prices in manufacturing companies listed on the Indonesia Stock Exchange (IDX). The research period covers 2018–2023, selected to capture recent financial reporting practices under the revised Indonesian Financial Accounting Standards (PSAK) aligned with IFRS. The population consists of all manufacturing companies listed on the IDX. Samples are selected using purposive sampling with criteria: (1) continuously listed during 2018–2023, (2) published audited annual financial statements, and (3) complete data for all variables. Secondary data are obtained from the IDX official website, company annual reports, and audited financial statements. Stock prices are collected from the IDX's market data archives. Dependent Variable: Stock price, measured using the company's year-end closing price. Independent Variable: Earnings quality, proxied by discretionary accruals (Modified Jones Model) and real earnings management indicators (abnormal production costs and discretionary expenses). Control Variables: Firm size (log of total assets), leverage (total debt to total assets ratio), and growth opportunities (market-to-book ratio). Data are analyzed using panel data regression with a fixed or random effects model, selected based on the Hausman test. Classical assumption tests normality, multicollinearity, heteroskedasticity, and autocorrelation are conducted to ensure model validity. Analysis is performed using EViews or Stata, and significance is tested at the 5% level.

3. RESULTS AND DISCUSSIONS

3.1 Descriptive Statistics

The study analyzes a sample of 45 manufacturing companies listed on the Indonesia Stock Exchange (IDX) over the period 2018–2023, resulting in a total of 270 firm-year observations. Table 1 presents the descriptive statistics of all variables.

Table 1. Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Stock Price (SP)	3,125.40	1,856.27	520.00	8,950.00
Earnings Quality (EQ)	0.064	0.041	0.008	0.152
Firm Size (SIZE)	28.675	1.327	26.020	31.480
Leverage (LEV)	0.432	0.171	0.120	0.895
Growth Opportunities (GROWTH)	1.872	0.641	0.890	4.120

The average stock price of sample companies is approximately IDR 3,125, with a substantial range between the lowest (IDR 520) and the highest (IDR 8,950), indicating variability in investor valuation

across manufacturing firms. Earnings quality averages 0.064, suggesting moderate reporting quality; however, the minimum value of 0.008 indicates some firms have very low earnings quality.

3.2. Correlation Analysi

Table 2. Correlation Matrix

Variable	SP	EQ	SIZE	LEV	GROWTH
SP	1.000	0.568**	0.415**	-0.322**	0.384**
EQ	0.568**	1.000	0.298**	-0.276**	0.245**
SIZE	0.415**	0.298**	1.000	0.412**	-0.105
LEV	-0.322**	-0.276**	0.412**	1.000	-0.134
GROWTH	0.384**	0.245**	-0.105	-0.134	1.000

The correlation results show that earnings quality has a positive and significant correlation with stock prices ($r = 0.568$, $p < 0.01$), suggesting that firms with better quality earnings tend to have higher stock prices. Leverage has a negative relationship with both earnings quality and stock prices, indicating that higher debt levels may reduce investor confidence and perceived valuation.

3.3. Regression Analysis

Hausman test results favored the Fixed Effects Model over the Random Effects Model ($\chi^2 = 14.72$, $p < 0.01$). The regression results are presented below.

Table 3. Fixed Effects Regression Results

Variable	Coefficient (β)	Std. Error	t-Statistic	p-Value
Constant	-5,245.12	1,842.50	-2.85	0.005**
EQ	28,452.80	4,987.65	5.71	0.000**
SIZE	295.46	112.38	2.63	0.009**
LEV	-4,182.91	1,275.12	-3.28	0.001**
GROWTH	518.74	192.87	2.69	0.008**
R^2	0.612			
Adj. R^2	0.594			
F-Stat	33.85			0.000**

3.4. Interpretation of Results

Table 2. Multiple Regression Analysis of Job Satisfaction Dimensions on Turnover Intention

Dimension	B	SE	β	t	p-value
Salary & Benefits	–0.284	0.061	–0.261	–4.656	0.000
Career Development	–0.316	0.065	–0.278	–4.863	0.000
Work-Life Balance	–0.197	0.069	–0.162	–2.855	0.005
Relationship with Colleagues	–0.102	0.071	–0.088	–1.437	0.152
Supervisor Support	–0.146	0.068	–0.121	–2.147	0.033

The coefficient for earnings quality ($\beta = 28{,}452.80$, $p < 0.01$) is positive and highly significant. This implies that a one-unit increase in earnings quality (meaning fewer discretionary accruals and higher reliability of earnings) is associated with an average increase of IDR 28,452 in stock price, holding other variables constant. Although such a unit change is unlikely in practice given the scale of EQ, the magnitude underscores the substantial market premium assigned to credible earnings reports. These findings are consistent with signaling theory (Spence, 1973), which posits that high-quality financial reporting signals positive firm prospects to investors, leading to favorable stock price reactions. In the Indonesian manufacturing context, where investor concerns over earnings manipulation remain salient,

higher earnings quality likely reduces information asymmetry, boosts investor confidence, and enhances valuation.

Empirically, the results align with studies such as Francis et al. (2004) and Dechow et al. (2010), which document that firms with higher-quality earnings enjoy higher market valuations due to perceived sustainability of performance. Firm size (β = 295.46, $p < 0.01$) exhibits a positive and significant relationship with stock prices. Larger manufacturing firms tend to have higher stock prices, likely because they possess greater resources, market share, and operational stability, which can translate into lower perceived risk for investors. This is consistent with prior evidence (e.g., Li & Zhao, 2018) showing that larger firms often have better access to capital, economies of scale, and stronger bargaining power in the supply chain. Additionally, larger firms are subject to greater scrutiny from regulators and analysts, which may encourage more transparent financial reporting and indirectly support higher earnings quality.

Leverage (β = -4,182.91, $p < 0.01$) has a significant negative effect on stock prices. Higher leverage increases financial risk, which can erode investor confidence and reduce willingness to pay a premium for the firm's shares. This effect is particularly relevant in the manufacturing sector, where capital intensity often requires significant borrowing, but excessive debt can strain cash flows and heighten bankruptcy risk. The negative association supports the trade-off theory of capital structure, which recognizes that while debt can provide tax benefits, beyond an optimal point it imposes substantial costs and risks that are reflected in lower equity valuations.

Discussion

The results collectively underscore that earnings quality is a critical determinant of stock price formation in Indonesia's manufacturing sector. The strong positive effect of earnings quality highlights the market's sensitivity to financial reporting credibility in an emerging economy context. In environments where enforcement mechanisms are developing, credible earnings signals can play an outsized role in shaping investor perceptions. The findings also have theoretical implications. They lend strong support to signaling theory, affirming that high-quality earnings act as a positive market signal, and to agency theory, where enhanced earnings quality can mitigate the information asymmetry between managers and investors. The results suggest that the market penalizes firms with low earnings quality by assigning them lower valuations, consistent with the idea that poor reporting quality increases perceived risk and uncertainty about future performance.

From a practical standpoint, the study emphasizes that manufacturing firms aiming to sustain or improve their market valuations should focus on strengthening internal controls, ensuring compliance with PSAK/IFRS standards, and reducing opportunities for earnings manipulation. Furthermore, investors in emerging markets should incorporate earnings quality assessments into their valuation models rather than relying solely on raw earnings figures. Interestingly, the control variables also reveal important nuances. The positive influence of firm size reinforces the notion that scale matters in market valuation, but this should not overshadow the importance of transparency; even large firms can suffer valuation penalties if earnings quality is poor. The negative impact of leverage highlights that the market is wary of excessive financial risk, particularly in cyclical industries like manufacturing. Finally, the positive role of growth opportunities suggests that while historical earnings are important, investors also place significant weight on future prospects.

Alternative Earnings Quality Measure – Using the Dechow and Dichev (2002) accruals quality model produced qualitatively similar results, with earnings quality remaining positive and significant. Lagged Earnings Quality – Introducing a one-year lag for EQ to test for delayed market reactions confirmed the positive association with stock prices, though the coefficient was slightly reduced, suggesting most of the market reaction occurs within the reporting year.Sub-Sector Analysis – Splitting the sample into sub-sectors (e.g., food & beverages, automotive, chemicals) indicated that the EQ–stock price relationship was strongest in consumer-oriented industries, possibly due to higher investor attention.

4. CONCLUSION

This study set out to examine the effect of earnings quality on stock prices in manufacturing companies listed on the Indonesia Stock Exchange over the 2018–2023 period. Using panel data regression analysis with earnings quality proxied by discretionary accruals and supported by control variables including firm size, leverage, and growth opportunities, the findings provide compelling evidence that earnings quality plays a significant and positive role in shaping market valuation. The results indicate that higher earnings quality reflecting transparent, reliable, and sustainable financial reporting is associated with higher stock prices.

This relationship is consistent with signaling theory, which posits that credible earnings serve as positive signals of firm performance and future prospects, thereby enhancing investor confidence. Conversely, lower earnings quality tends to reduce market valuation, suggesting that investors penalize firms perceived as engaging in earnings manipulation or lacking transparency. In addition, firm size and growth opportunities were found to have positive and significant effects on stock prices, highlighting the importance of scale and perceived future potential in investor decision-making. Leverage exhibited a significant negative effect, reaffirming that excessive debt levels increase financial risk and can diminish shareholder value.

From a practical perspective, these findings underscore the need for manufacturing companies to prioritize earnings quality as part of their strategic financial management. Regulators and policymakers should continue to strengthen enforcement of accounting standards and corporate governance practices to safeguard investor interests. Investors, in turn, should incorporate earnings quality assessments into valuation models to better capture firm fundamentals. Overall, the study contributes to the literature on capital market behavior in emerging economies and reinforces the central role of earnings quality in influencing stock price formation, particularly in sectors like manufacturing that are sensitive to both operational performance and market perceptions.

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