CHAPTER II
LITERATURE REVIEW

2.1 Theoretical Review

2.1.1 Signaling Theory

According to Helina & Permanasari (2017), a signal is the company's management action, which gives information to investors about how management perceives the company's prospects. The signal theory is often used by banks to give signals to external parties to show how management views the company's prospects in the future. The signals that have been sent to the parties will be used as a basis for decision-making in the banking industry. Furthermore, announcements regarding financial data and company conditions that have been received by the parties will be processed and interpreted as good or bad news.

If the information is positive, then investors will respond positively and be able to distinguish whether the company is of good quality, so the stock price will increase and the value of the company will increase too. But on the contrary, if investors give a negative signal, it indicates that investors' desire to invest is decreasing which will affect the value of the company itself. In this theory, the company's management acts as an internal that gives signals in the form of financial statements to investors which are referred to as external parties.

Signaling theory has a link to liquidity ratios, the higher the company's ability to repay short-term debt, then it will be able to give a good signal to investors which indicate that the company can repay its debts. Therefore, the higher the value of a company's liquidity ratio, the company's success in paying other debts will also increase. In addition, this signaling theory also has a link to the leverage ratio that will be proxied by the debt ratio. This ratio is commonly used to measure how far a company can pay off its debts and measure the funds derived from debt. If a company used funds that come from high debt, it will be even more difficult to repay its debts. Therefore, it can be concluded that the lower the debt ratio is, the better the signal sent to investors or other parties.

2.1.2 Agency Theory

According to Marsela & Maryono (2017)**,** agency theory is a theory that explains the relationship between the principal (owner) and the agent (management) or the so-called agency relationship. The concept of this theory is a relationship that can be in a form of providing work by the principal to the agent who carries out duties that are beneficial to the principal, including the delegation of decision-making authority from the principal to the agent. If there is a case where the agent takes action outside the agreement at the beginning, this will be the cause of an agency conflict and in the end, it will create the emergence of agency costs. The function of this cost agency itself is so that the agent does not take actions out of the agreement.

Wati & Putra (2017) said that the importance of profit information in the company's financial statements causes managers to carry out various ways to compile financial statements as effectively as possible for both internal and external parties. This often triggered the emergence of information asymmetry between management and principals known as agency conflicts. The result that arises when management reports profits opportunistically for its purposes is that the earning quality generated will be low. In the end, when it happened, the party who uses it will make a wrong decision. Therefore, making the earning quality a tool to assess the quality of financial information will overcome the problems caused by one party.

2.1.3 Company Size

Brigham & J. Houston (2010) states that the company size is seen from the total assets, total sales, amount of profit, and others. Company size is a large scale of companies that can be classified in various ways, including by size of income, total assets, and total equity. The size of the company is an indicator that provides clues about the condition of the company where several benchmarks can be used to determine the size of a company starting from the number of employees owned, the number of assets owned, the total shares outstanding, and the achievement of the number of sales achieved by the company at a time. According to Irawati (2012) in

Jaya & Wirama (2017), the size of the company is related to earning quality because the larger the size of the company is, the higher the business continuity of a company in improving financial performance. Therefore, the company does not need to carry out profit manipulation practices.

2.1.4 Liquidity

Liquidity is company’s ability to pay off debts that are maturing within a year or short-term (Brigham & J. Houston, 2020:107). It is also known as a company measuring tool for paying off short-term debt on time. An illiquid company means that the company is unhealthy. According to Musthafa (2017) in Sari et al. (2021), if a company can maintain great operation activities, then the company can pay off its debt that has a short period**.** The advantage obtained if a company has a high level of liquidity is that investors will be interested in making investments which will have an impact on increasing the company's profits. Nugroho & Radyasa (2019) states that if the company's liquidity is high, it is notnecessarily that the earning quality generated is good anyway. That the better the company meets debts and obligations there is no guarantee that the earning quality is also in good condition.

2.1.5 Leverage

According to Brigham & J. Houston (2010), financial leverage is a measurement that shows how far debt is used in a company's capital structure. Leverage describes the relationship between a company's debt and capital. The company is good if it has more capital than debt. The debt owned by the company is related to the benefits that will be obtained by the company.

This analysis is used to measure how much funds the company's owner provides in proportion to the funds obtained from the company's creditors or to measure how far the company has been funded by long-term debts. High levels of debt can weaken the value of a company, as high levels of debt can raise concerns about the company's default. The more debt a company uses in relation to its total assets, the greater its financial leverage is. Companies with high leverage cause investors to have less confidence in the profits published by the company. Investors assume that the company will prioritize debt repayment of debtholders over dividend payments. According to Murniati et al. (2018), if the number of leverages is high, it will encourage management to do various ways to keep getting investors, one of those ways is by not reporting the real financial condition of the company. The existence of financial statements that are not presented according to the conditions of the company will affect the profit item, which is a decrease in the earning quality. This is because the profit is included in the financial statement items and is not presented based on actual conditions.

On the other hand, if the leverage is low, then it shows that the company has only a few debts and shows that the company's condition is getting better. This encourages the company to present real financial information to show the good condition of the company. Then the higher the leverage ratio, the earning quality will be low. Conversely, if the leverage is low, the quality of profit will be high. (Murniati et al., 2018).

2.1.6 Earning Quality

Statement of Financial Accounting Standards (PSAK) No. 1 states that providing information for users of financial statements regarding the financial position, financial performance, and cash flow will be useful for decision-making. The earning quality can be used as a reason to predict future performance. Earning quality is used to assess the performance of a company that can be used as a basis for predicting future performance.

Profit is declared to be of high quality if the reported one can be used to make the best decisions by the users of the report. The earning quality is an important aspect to evaluate whether the company's existing finances are in good health or vice versa. Financial quality can make a description of the company’s financial condition either at the present time or in the future as a prediction.

A quality profit shows optimism that can predict the next profit (Kepramareni et al., 2021). The earning quality is higher if it approaches the initial planning or exceeds the target of the original plan. The earning quality is low if the profit is not by the actual profit so the information obtained from the profit statement becomes distorted and the impact is misleading creditors and investors in making decisions (Salma & Riska, 2019).

2.2 Empirical Review

Research on the topic of the influence of leverage, company size, and liquidity has been widely carried out by previous researchers. however, there are differences in results or what is also called research gaps in these studies. therefore, it would be interesting for the author to re-research this topic.

Research conducted by Jaya & Wirama (2017) used variables of the investment opportunity set, liquidity, and company size on earning quality with research object all companies listed on the Indonesia Stock Exchange period 2015. results showed that the company's size affects earning quality, liquidity does not affect earning quality, and the set of investment opportunities has a negative effect on earning quality.

Research conducted by Khatarina et al. (2021) used the variables of Profitability, Liquidity, and Capital Structure on earning quality with the object of research being business institutions of food and beverage listed on the Indonesia Stock Exchange in the 2017 – 2019 period. The results of the study showed that the profitability variable has a negative and significant effect on earning quality, company size has negative and significant effect on earning quality, Liquidity has no significant effect on earning quality, and capital structure has no significant effect on earning quality.

Research conducted by Yusra (2016) used the variables of solvency and liquidity on profitability with the object of five companies in the Indonesia Stock Exchange for the period 2007-2014. the results of the study showed that liquidity has a positive but has no significant effect on the profitability of the company and solvability has a positive and significantly affects the profitability.

Research conducted by Nainggolan & Abdullah (2019) used the variables of profit growth, Profitability, liquidity, and Company Size on the earning quality with the object of research on manufacturing companies in the food and beverage sub-sector consumer goods listed on the Indonesia Stock Exchange for the 2015-2020 period. research results show that liquidity has no significant effect on earning quality. Profit growth has a partial effect on earning quality. Profitability does not affect earning quality, and company size affects earning quality.

Research conducted by Murniati et al. (2018) using the variables of Public Accounting Firm Company Size, Institutional Ownership, Conservatism, Investment Opportunity Set, Independent Commissioner of liquidity, and leverage on the earning quality with the object of research of manufacturing companies listed on the Indonesia Stock Exchange during the period 2012-2016. The results of the study showed that the variable Leverage did not affect the earning quality, liquidity does not affect the earning quality, KAP reputation has a positive effect on the earning quality, Conservatism does not affect the earning quality, and investment opportunity set (IOS) has a positive effect on the earning quality.

Research conducted by Lumbantoruan et al. (2021) uses the variables solvability, company size, and financial performance on income growth with the research object companies listed on the IDX from 2017-2019. Research results show that solvability has no effect on income growth, and Company size has no effect on income growth. financial performance does not affect income growth.

Research conducted by Wati & Putra (2017) on those who use the variables of Company Size, Leverage, and Good Corporate Governance on the earning quality with the object of research companies listed on the Indonesia Stock Exchange (IDX) in 2010-2014. Research results show that the variable Good Corporate Governance has a positive effect on the earning quality, leverage has a positive and insignificant effect on the earning quality, and the company size has a negative and significant effect on the earning quality.

Table 2.1 Empirical Review

No.	Author (Year)	Variables	Object	Result
1.	Jaya & Wirama (2017)	Dependent variable: Earning Quality Independent variables:	84 companies listed on Indonesia Stock Exchange period 2015	The company's size affects earning quality, liquidity has no effect on earning quality, and the set

		Investment, Opportunity Set, Liquidity, Company Size		of investment opportunities has negative effect on earning quality
2.	Khatarina et al. (2021)	Dependent variable: Earning Quality Independent Variable: Profitability, Liquidity, and Capital Structure	Companies listed on the IDX from 2017 - 2019	The profitability variable has negative and significant effect on the earning quality, company size has negative and significant effect on earning quality, Liquidity has no significant effect on the earning quality, andcapital structure has no significant effect on the earning quality.
3.	Yusra (2016)	Dependent variable: profitability ratio Independent variables: Liquidity, solvability	5 companies in the Indonesia Stock Exchange for the period 2007-2014.	Liquidity has a positive but not significantly affects the profitability of the company and solvability has a positive and significantly affects the profitability.
4.	Nainggolan & Abdullah (2019)	Dependent variable: profitability ratio	Manufacturing companies in the food and beverage sub-sector	Liquidity has no significant effect on earning quality. Profit growth has a partial effect on

		Independent variables: profit growth, Profitability, liquidity, and Company Size	consumer goods listed on the Indonesia Stock Exchange for the 2015- 2020 period	earning quality. Profitability has no effect on earning quality, and the company size has an effect on earning quality.
5.	Murniati et al. (2018)	Dependent variable: profitability ratio Independent variables: Public Accounting Firm Company Size, Institutional Ownership, Conservatism, Investment Opportunity Set, Independent Commissioner of liquidity, and leverage	Manufacturing companies listed on the Indonesia Stock Exchange from the period 2012- 2016	Leverage had no effect on the earning quality, liquidity does not affect the earning quality, KAP reputation has a positive effect on the earning quality, Conservatism does not affect the earning quality, and investment opportunity set (IOS) has a positive effect on the earning quality
6.	Lumbantoruan et al. (2021)	Dependent variable: income growth Independent variables: solvability, company size,	Companies listed on the IDX from 2017- 2019	Solvability has no effect on income growth, and Company size has no effect on income growth. financial performance has

		and financial performance		no effect on income growth
7.	Wati & Putra (2017)	Dependent variable: earning quality Independent variables: Company Size, Leverage, and Good Corporate Governance	Companies listed on the Indonesia Stock Exchange (IDX) in 2010-2014	Good Corporate Governance has a positive effect, leverage has a positive effect on the earning quality, and the company has a negative and insignificant effect on the earning quality.

This research is different from the previous studies, because the researcher use three specific variables such as company size, liquidity, and leverage to see the effect on earning quality. In the other hand, the previous studies used more various variables with different research results. There is no research that discusses the combination of three variables with the current period of time that the researcher uses to see the effect on earning quality in the banking industry.

2.3 Conceptual Framework and Research Hypothesis

2.3.1 The Effect of Company Size on Earning Quality

The company size is an indicator that provides clues about the condition of the company where there are several benchmarks that can be used to determine the size of a company starting from the number of employees owned, the number of assets owned, the total shares outstanding and the achievement of the number of sales achieved by the company at a time. According to Jaya & Wirama (2017), the relatively good performance of the company will be seen by the public so the company will be more careful in reporting its financial condition, more informative about the information contained in it, and more transparent so that the company will be less in carrying out profit management. According to Khatarina et al. (2021), the size of the company is related to the quality of income every time the higher the business institution, the greater the continuity of its business in providing improved performance in financial aspects, therefore business institutions do not need to carry out income manipulation actions.

In the previous study conducted by Jaya & Wirama (2017), it was stated that company size affect earning quality. The research hypothesis can be formulated based on the previous explanation.

H1: Company size affects Earning Quality.

2.3.2 The Effect of Liquidity on Earnings Quality

Liquidity is a ratio that works to measure a company's ability to meet its short-term obligations. if the company can fulfill its obligations, it means that the company is liquid, while if the company is unable to fulfill its obligations, it means that the company is liquid.

According to Ginting (2017) High liquidity indicates that the company's financial condition is in a fairly good state and is capable of paying off all current liabilities promptly. When this happens, it can give a good impression to the creditor, which in the end will have an impact on the emergence of trust between the creditor and the company by not hesitating to lend funds and which of course will be used by the company to generate other profits.

The current ratio, one of the most frequently cited financial ratios, measures the company's ability to meet its short-term obligations. The current Ratio is Current Assets divided by Current Liabilities. A higher current ratio indicates a higher level of liquidity (Gitman and Zutter, 2015 in Marpaung, 2019). So, in this research, liquidity will be proxied using the Current Ratio (CR). The current ratio is one way to calculate the liquidity ratio of a company. by using the current ratio (CR), we can find out the level of the company's ability to meet its short-term obligations by using the company's current assets.

In the previous study, Marpaung (2019) it was stated that liquidity affects earning quality. based on the previous explanation, the research hypothesis can be formulated as follows.

H2: Liquidity affects the Earning Quality.

2.3.3 The Effect of Leverage on the Earning Quality

Leverage is usually used to see the extent to which the company has been financed by debt or external parties. The capital of a company can be sourced from many places, one of which is debt or leverage. leverage itself is a ratio associated with capital loans to finance the activities of an enterprise or to develop such a company. In this research, leverage will be proxied using DER (Debt to Equity Ratio).

According to Murniati et al. (2018) this ratio shows the company's ability to fulfill all its financial obligations if the company is being liquidated, so leverage is the company's ability to repay its debts, both long-term and short-term. When a company is identified to have a high level of leverage, then the company can be sure to have difficulty in fulfilling its obligations, both short-term and long-term. this will have an impact on the company's condition in the future, where the company will find it difficult to get capital loans from external parties to meet the company's operational activities.

However, according to Wati & Putra (2017), Although the company has a high level of leverage ratio and the possibility of a high level of risk, it also does not mean that the company has low earning quality and prospects in the future. The greater the debt of a company, the more it reflects earning quality.

Therefore, in previous Wati & Putra (2017) studies, it was stated that leverage affects earning quality. The research hypothesis can be formulated based on the previous explanation.

H3: Leverage affects the Earning Quality

2.3.4 Conceptual Framework

Based on the background, empirical reviews, and theoretical reviews that have been stated previously in this research, here is the conceptual frameworks that will be used to test leverage, liquidity, and company size on earning quality. The following Figure 1.1 is an overview of the relationship between the independent variable (X) and the dependent variable (Y). The independent variables used in this study are company size (X1), liquidity (X2), and leverage (X3), while the dependent variable used by the author is the earning quality (Y):

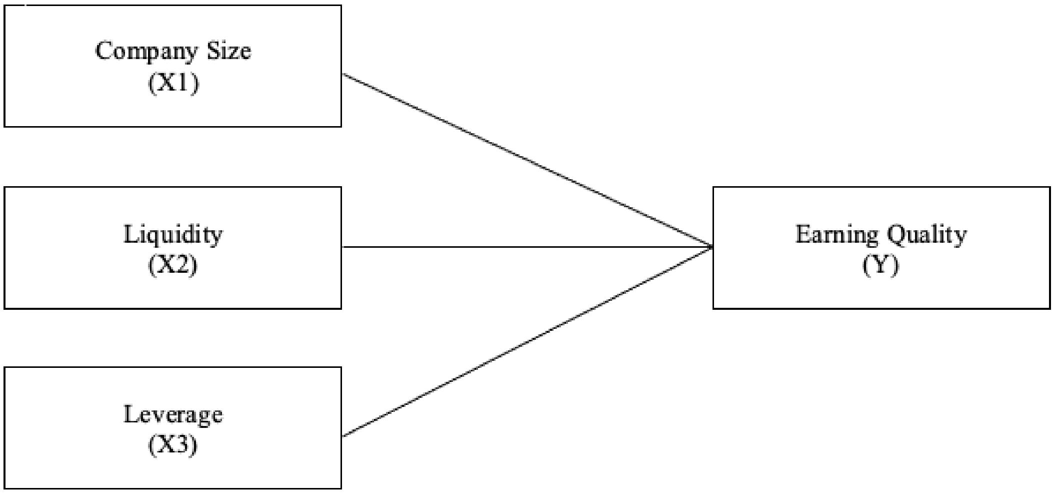

Figure 2.1 Conceptual Framework