Profit Quality, and Capital Structure: Dynamic Panel Analysis on Manufacturing Companies on IDX

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ABSTRACT

Capital structure decisions play a critical role in shaping financial reporting behavior and the sustainability of firms in emerging capital markets. This study aims to examine the effect of capital structure, proxied by leverage measured using the debt ratio, on profit quality measured by discretionary accruals, while controlling for company size and sales growth. This study employs a quantitative approach using panel data from manufacturing companies listed on the Indonesia Stock Exchange for the period 2015–2024. A dynamic panel data model is estimated using the GMM Arellano–Bond estimator to address potential endogeneity and to examine both short-run and long-run effects of capital structure on profit quality. The estimates indicate a decline in profit quality associated with growing debt under a leverage capital structure, as financial reporting quality deteriorates and contractual pressures and profit management conflicts escalate. In contrast, a positive relationship exists between profit quality and company size and sales growth, such that companies with larger operations and better sales performance are more likely to produce financial statements of higher quality. The results indicate a need to balance debt and Equity financing to maintain the quality of reporting and the business's viability in Indonesia's capital markets.

Keywords: *Capital Structure, Discretionary Accruals, Dynamic Panel Data, Leverage, Profit Quality.*

INTRODUCTION

Profit quality is a central issue in financial accounting because it underpins the credibility of financial information used by academics, practitioners, and regulators (Habib et al., 2022; Abed et al., 2022). As the outcome of the accounting process, profit reflects a firm's financial value and performance and serves as a key basis for evaluating future prospects and risks in investment and financing decisions (Bisogno & Donatella, 2022; Olayinka, 2022). Consequently, high-quality profits provide reliable, relevant, and manipulation-free information that accurately represents a firm's economic condition, whereas low-quality profits may mislead financial statement users and adversely affect capital markets and the broader economy (Alves, 2023; Mesioye & Bakare, 2024).

In the accounting literature, profit quality is closely linked to earnings management practices undertaken by managers to achieve performance targets or maintain cash flow stability (Kliestik et al., 2021; Agha & Rashid, 2023). Such practices, implemented through accounting policy choices or direct intervention in financial reporting, reduce information credibility because reported profits no longer reflect firms' actual economic conditions (Shakespeare, 2020; Chen et al., 2023). Discretionary accruals are widely used to measure profit quality, as they capture the extent of managerial discretion in the accrual process, with higher discretionary accruals indicating greater earnings management and lower profit quality (Mardessi, 2022; Hsu & Yang, 2022). Lassoued and Khanchel (2025) document that the COVID-19 pandemic significantly affected earnings management

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behavior and profit reporting quality. Profit quality is also shaped by corporate governance characteristics, particularly board independence and the financial literacy of female directors, as well as by macroeconomic conditions, investment dynamics, and technology-based financial inclusion in Indonesia (Priyanto et al., 2022; Juwita et al., 2023; Amanamah, 2024).

The relationship between financing decisions and profit quality is important because the use of debt can influence managerial incentives in financial reporting (Helman et al., 2022; Naz & Sheikh, 2023). A firm's financing arrangement reflects how it balances equity and debt instruments to fund operational and investment activities (Kruk, 2021; Schell et al., 2025). Classical capital structure theory, particularly the Modigliani and Miller proposition, argues that capital structure does not affect firm value in a frictionless market; however, this assumption is unrealistic because it ignores taxes, bankruptcy costs, and information asymmetry (Çam & Özer, 2022; Lubis et al., 2023). In practice, the trade-off theory suggests that firms pursue an optimal capital structure by balancing the tax advantages of debt against the costs of financial distress, while the pecking order theory posits that firms prefer internal funds, followed by debt and equity, due to differing costs arising from information asymmetry (Islam et al., 2022).

High levels of debt can pressure managers to meet interest and principal obligations, increasing incentives for earnings management to present more favorable performance to creditors and investors (Okyere et al., 2021; Zimon et al., 2021). Highly leveraged firms may manipulate accruals to comply with debt covenants, thereby reducing profit quality, particularly when capital structures are debt-dominated (Kalembe et al., 2024; Tanko, 2025). In contrast, firms with more balanced debt and equity structures tend to face lower earnings management incentives and exhibit higher profit quality (Kartika et al., 2023). In emerging markets such as Indonesia, profit quality is critical for firm sustainability amid intense competition, especially in the manufacturing sector, which is capital-intensive and relies heavily on debt to finance production and investment activities (Viphindrartin et al., 2022; Triatmanto & Bawono, 2023). These conditions highlight the need to examine whether leverage undermines profit quality or instead disciplines managerial financial reporting in Indonesian manufacturing firms.

Despite extensive international evidence, it remains unclear whether leverage affects the profit quality of Indonesian manufacturing firms in a similar manner. In the context of Indonesia's capital market, empirical evidence on the relationship between capital structure and profit quality remains limited, particularly given creditor pressures, financing constraints, and the capital-intensive nature of the manufacturing sector (Putri & Willim, 2024). Therefore, it is essential to examine whether leverage deteriorates profit quality or instead plays a different role in shaping financial reporting behavior in Indonesian manufacturing firms.

This study examines the relationship between capital structure and profit quality using a dynamic panel data approach. Employing the Generalized Method of Moments (GMM) Arellano–Bond estimator to address endogeneity, the analysis investigates both short-run and long-run effects for manufacturing firms listed on the Indonesia Stock Exchange during 2015–2024. The findings show that leverage, along with company size, sales growth, and prior profit quality, significantly influences current profit quality, reflecting the dynamic nature of financial reporting behavior. This study contributes to the accounting and finance literature by providing empirical evidence on information risk, offering guidance for managers in determining optimal capital structures, and delivering practical insights for investors and regulators in strengthening capital market oversight.

LITERATURE REVIEW & HYPOTHESIS DEVELOPMENT

Accounting Theory and Profit Quality

These elements are integrated into a theoretical framework that underpins the empirical examination of the relationship between capital structure and profit quality in Indonesian manufacturing firms (Hastutik et al., 2022; Kartika et al., 2023). Profit quality is a complex and multidimensional concept in accounting literature (Bisogno &

Donatella, 2022). High-quality profits reflect a firm's true financial position and performance, are difficult to manipulate, and provide reliable information for predicting future cash inflows (Velte, 2021; Tran, 2022). Accurate cash flow forecasting is central to assessing a firm's future prospects, making profit quality a critical indicator. Conversely, low profit quality is associated with inefficient investment decisions and misallocation of resources (Islam et al., 2022).

A key determinant of profit quality is earnings management, which occurs when managers exploit accounting discretion or intervene in financial reporting to achieve specific objectives, such as meeting profit targets, stabilizing cash flows, or complying with contractual obligations (Kliestik et al., 2021; Zalata et al., 2022). Such practices weaken profit quality because reported earnings no longer fully represent underlying economic conditions (Durana et al., 2021; Chen et al., 2023). In empirical accounting research, profit quality is commonly measured using discretionary accruals, which capture the portion of accruals influenced by managerial judgment, as opposed to non-discretionary accruals that more closely reflect economic reality (Habib et al., 2022; Mardessi, 2022). An increase in discretionary accruals is generally interpreted as an indication of intensified earnings management and declining profit quality (Okyere et al., 2021; Jamadar et al., 2022). Several models are widely used to estimate discretionary accruals, including the Jones, Modified Jones, and Kothari models (Zimon et al., 2021; Suk Yoon et al., 2022). Consequently, profit quality reflects the balance between a firm's economic fundamentals and its financial reporting policies (Kalembe et al., 2024).

Capital Structure Theory and Profit Quality

In addition to accounting theory, this research is also based on capital structure theory (Kruk, 2021). Capital structure refers to the composition between debt and equity that a company uses to finance operational and investment activities (Çam & Özer, 2022; Jariah & Lukiana, 2023). Modigliani and Miller's theory became the initial basis for understanding the structure of capital (Naz & Sheikh, 2023). Under perfect market conditions with no taxes, bankruptcy costs, and information asymmetry, Modigliani and Miller argue that capital structures do not affect a company's value (Tran, 2022). However, in reality, the existence of these factors makes the capital structure relevant (Kartika et al., 2023). The trade-off theory states that companies will balance the benefits of using debt in the form of tax savings with increased bankruptcy costs as leverage increases (Putri & Willim, 2024). High-leverage companies can indeed enjoy tax savings, but also face a greater risk of bankruptcy (Tanko, 2025). Therefore, companies need to look for optimal points in the capital structure that maximize the company's value (Naz & Sheikh, 2023).

Pecking order theory provides a different perspective by emphasizing that companies have preferences in choosing financing sources (Rodriguez, 2024). Companies prefer internal financing, then debt, and finally equity (Tran, 2022). This preference is based on the different information costs among the three sources (Çam & Özer, 2022). In-house financing is considered the cheapest because it does not cause information asymmetry problems, while equity issuance is considered the most expensive because it can cause negative signals to the market (Kruk, 2021). In the context of profit quality, the use of high debt can put pressure on managers to meet interest and principal payment obligations, potentially driving profit management practices (Okyere et al., 2021).

The Effect of Leverage on Profit Quality

Previous research on the relationship between leverage and profit quality has shown mixed results (Habib et al., 2022). Several studies have found that leverage has a negative effect on profit quality (Naz & Sheikh, 2023; Kartika et al., 2023). Contractual pressure from creditors compels managers to perform profit management to make financial statements look better (Chen et al., 2023). For example, research in the United States and Europe shows that companies with high leverage tend to have greater discretionary accrual rates, so the quality of profits decreases (Velte, 2021; Lassoued & Khanchel,

2025). Another study found that debt can serve as a disciplinary mechanism that limits managers' opportunistic behavior (Zimon et al., 2021). From the perspective of agency theory, debt can reduce the free cash flow available to managers to use inefficiently, thereby improving the quality of profits (Kalembe et al., 2024).

In Indonesia, research on the relationship between leverage and profit quality is still relatively limited (Putri & Willim, 2024). Several studies have shown that leverage has a negative effect on the quality of profits, in line with findings in other countries (Kartika et al., 2023). However, there are also studies that have found that the influence of leverage is not significant, or even positive, depending on the characteristics of the company and the industrial sector (Widarni & Bawono, 2021; Priyanto et al., 2022). These differences in results show that the relationship between capital structure and profit quality is contextual, depending on regulations, corporate governance, and capital market conditions in each country (Viphindrartin et al., 2022; Triatmanto & Bawono, 2023).

H1: Leverage has a negative effect on profit quality.

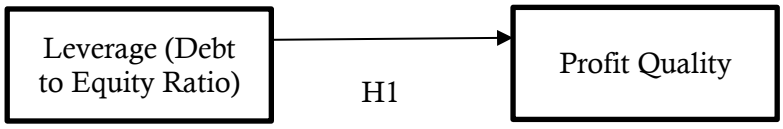

Figure 1. Conceptual Framework

Figure 1 presents the conceptual framework of the study, showing leverage, measured by the debt-to-equity ratio, as the main variable influencing profit quality. This relationship reflects the assumption that capital structure decisions affect managerial behavior in financial reporting. Company size and sales growth are included as control variables to capture firm-specific characteristics and operational performance that may also affect profit quality, ensuring a more comprehensive and unbiased analysis.

RESEARCH METHODS

Quantitative methodology with an explanatory research design is employed in this study to investigate the causal effect of capital structure on profit quality among manufacturing firms listed on the Indonesia Stock Exchange (IDX). The analysis draws on secondary data extracted from audited annual financial statements spanning the period 2015–2024, enabling a longitudinal examination of firm behavior over time. Given the capital-intensive nature of manufacturing firms and their heavy reliance on external financing, this sector provides a particularly relevant setting for exploring the interplay between leverage and profit quality. To address potential endogeneity and capture dynamic relationships, the study adopts a dynamic panel data approach estimated using the Arellano–Bond Generalized Method of Moments (GMM) estimator, which yields consistent and unbiased estimates even in the presence of unobserved heterogeneity and lagged dependent variables.

Profit Quality (EQ) serves as the dependent variable and is measured by discretionary accruals, estimated through the Modified Jones model. Higher levels of discretionary accruals signal greater earnings management and thus lower profit quality, while lower levels indicate higher-quality earnings that more faithfully reflect underlying economic performance. The primary independent variable is leverage, proxied by the Debt-to-Equity Ratio (DER), which captures the degree of debt reliance relative to equity and the associated financial risk and creditor pressure that may shape financial reporting incentives. To isolate this relationship, two control variables are incorporated: company size, computed as the natural logarithm of total assets to account for differences in scale, resources, and internal control strength; and sales growth, calculated as the annual percentage change in sales to control for operational performance and expansion effects that may independently influence profit quality.

The econometric specification is a dynamic model expressed as:

$$EQ_{it} = \alpha EQ_{i,t-1} + \beta_1 Leverage_{it} + \beta_2 Size_{it} + \beta_3 Growth_{it} + \varepsilon_{it}$$

where EQ_{it} denotes profit quality (discretionary accruals) for the firm i in period t, $EQ_{i,t-1}$ represents lagged profit quality to capture persistence and dynamic effects, $Leverage_{it}$ is the debt-to-equity ratio, $Size_{it}$ is firm size, $Growth_{it}$ is sales growth, and ε_{it} is the error term. The inclusion of the lagged dependent variable renders the model dynamic, allowing past profit quality to influence the current period. Within the GMM framework, lagged values of the dependent variable and predetermined regressors serve as internal instruments to address endogeneity, under the moment condition $E[Z'_{it}\varepsilon_{it}] = 0$, where Z_{it} is the instrument matrix comprising valid lagged and exogenous variables.

Estimation proceeds using both one-step and two-step Arellano–Bond GMM procedures. The one-step estimator assumes homoscedastic errors and delivers consistent results, whereas the two-step version enhances efficiency by accounting for heteroscedasticity and autocorrelation, with robust standard error corrections applied to mitigate downward bias in standard errors. This approach generates reliable estimates that reflect both short-run and long-run relationships. Model validity is confirmed through standard diagnostics: the Hansen test for overidentifying restrictions ensures instrument exogeneity, while the Arellano–Bond AR(1) and AR(2) tests verify the expected first-order autocorrelation and absence of second-order autocorrelation, respectively. Collectively, these procedures provide robust empirical evidence on how capital structure influences profit quality in Indonesian manufacturing firms.

RESULTS

The section on outcomes and debates presents the author's personal discoveries and evaluations of the Generalized Method of Moments (GMM) Arellano-Bond dynamic panel model. Such analysis was conducted on the financial statements of manufacturing firms listed on the Indonesia Stock Exchange for the period 2015-2024.

Table 1. Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Profit Quality	0.532	0.124	0.21	0.82
Leverage	0.421	0.201	0.05	0.85
Company Size	12.34	1.56	9.80	15.50
Sales Growth	0.087	0.072	-0.10	0.35

Table 1 presents the descriptive statistics of the study variables. Profit quality has a mean of 0.532 with a standard deviation of 0.124, indicating moderate variation across firms, with values ranging from 0.21 to 0.82. Leverage shows an average of 0.421, suggesting that 42.1% of total assets are financed by debt, with considerable dispersion (min 0.05; max 0.85), reflecting differences in capital structure policies among firms. Company size records a mean of 12.34 and a standard deviation of 1.56, indicating variation in firm scale within the sample.

Sales growth has a mean of 0.087 (8.7%), suggesting that firms experienced positive growth on average, although some faced contraction (min -0.10) while others expanded substantially (max 0.35). The variability observed across all variables supports the appropriateness of panel data estimation to examine the relationship between capital structure and profit quality.

Table 2. Correlation Matrix

Variable	Profit Quality	Leverage	Company Size	Sales Growth
Profit Quality	1	-0.45	0.52	0.38
Leverage	-0.45	1	-0.12	-0.08
Company Size	0.52	-0.12	1	0.25
Sales Growth	0.38	-0.08	0.25	1

As shown in Table 2, the correlation matrix provides an initial picture of the relationships among the variables before conducting the dynamic panel estimation. Profit Quality is moderately negatively correlated with leverage (-0.45), suggesting that firms with higher debt levels tend to exhibit lower profit quality. This preliminary relationship aligns with the notion that greater financial pressure may encourage earnings management or reduce reporting quality.

On the other hand, profit quality shows a positive correlation with company size (0.52) and sales growth (0.38). This indicates that larger firms and those experiencing stronger sales performance generally report higher-quality earnings. Meanwhile, the correlations among the independent variables are relatively low (all below 0.30 in absolute value), suggesting no serious multicollinearity concerns. Table 2 presents reasonable and theoretically consistent associations that support further analysis using the GMM approach.

The model used includes dependent variables in the form of profit quality measured by discretionary accruals, the main independent variable in the form of leverage, and control variables in the form of company size and sales growth. To provide a clearer picture of the estimated results, Table 1 of the GMM coefficient calculation results is presented.

Table 3. Estimated Arellano-Bond GMM Coefficient

Variable	Coefficient (β)	Std. Error	t-Statistics	Significance
EQ (t-1)	0.421	0.073	5.76	***
Leverage (DER)	-0.287	0.092	-3.12	**
Company Size	0.154	0.061	2.52	**
Sales Growth	0.198	0.084	2.36	**
Constant	0.067	0.045	1.49	Ns

Information:

- significant at the level of 1%
- ** significant at the level of 5%
- ns = insignificant

Table 3 shows that, judging by the estimation results, the prior-period quality variable (EQ) had a statistically significant positive coefficient. This suggests that the effect was not only present but consistent. In other words, the quality of profit in the prior period affected the profit quality of the present period. This finding resonates with profit management practices established in the accounting literature, as they tend to be recursive; thus, the profit quality behavior is dynamic.

The negative coefficient of 0.287 for the debt-to-equity ratio indicates that the company's profit decreases as the debt-to-equity ratio increases. This loss of profit correlation is consistent with debt ratio accounting and finance theory, which indicates that high-leverage firms will experience losses when Equity profit is manipulated. Such companies will be controlled by high-profit stakeholders within the company who will be high-profit creditors. A company will have to engage in profit manipulation to achieve the realized profit. As a result, such companies will lose to profit manipulation, leading to lost profits and overall poor profit quality. This indicates that firms with a high debt ratio as a significant component of their capital structure will be adversely affected by poor-quality financial records.

The company's size, as measured by a coefficient of 0.154, is positively correlated with profit quality and is statistically significant at the 5% level. It indicates that the larger the company, the higher the profit quality, and thus the more business activities it can pursue. Larger businesses can improve their internal control structures, increase resource availability, and be more likely to achieve efficient processing and improvements in their activities to attain higher profits. The literature supports the idea that the company's size is positively correlated with the quality of its financial statements, and thus, greater profits

are likely. There is also a greater risk of loss of management control, so discretion in the management of the internal control system is less likely to result in its abuse.

Profit quality is positively correlated with sales growth at the 5% significance level. It implies that a company is likely to have profit quality when sales growth is higher. The company's economic circumstances are better when it indicates higher profits, strong operational efficiency, and business activity, leading to high sales growth. In companies with positive sales growth, profit management is less likely to be in place and less likely to be changed, and financial malfeasance is less likely to be needed.

Table 4. GMM Diagnostic Tests Results

Test	Statistic Value	p-Value	Conclusion
Arellano–Bond AR(1)	z = -3.08	0.002	Significant (expected)
Arellano–Bond AR(2)	z = 0.64	0.522	Not significant
Hansen Overidentification	χ^2 = 10.95 (df = 9)	0.270	Instruments valid

Table 4 shows that, according to the Hansen test, the instrument was confirmed as valid, as the p-value of 0.27 indicated no association with the error term. Regarding the Arellano-Bond AR(1) test, first-order autocorrelation was found to exist and be statistically significant. However, AR(2) showed no significant autocorrelation; therefore, the dynamic model specifications would be deemed valid.

DISCUSSION

The findings of this study indicate that leverage has a negative effect on profit quality, as high levels of debt create financial pressure that encourages managers to prioritize short-term financial appearance over the faithful representation of economic performance. In the accounting literature, profit quality is closely associated with earnings management practices, both accrual-based and real activities. Consistent with this view, Habib et al. (2022) explain that financially pressured firms are more likely to engage in earnings management, while Naz and Sheikh (2023) and Okyere et al. (2021) find that highly leveraged firms manipulate accruals to meet debt obligations and maintain credibility with creditors. Tran (2022) further emphasizes that such practices weaken profit quality because reported earnings deviate from the firm's underlying economic fundamentals.

From the perspective of earnings management theory, managers are assumed to act opportunistically when facing certain incentives. In line with this view, Kliestik et al. (2021) argue that managerial discretion over accounting choices is frequently used to serve specific interests. Empirical evidence from Zimon et al. (2021) supports this argument by showing that firms with high leverage tend to manage earnings to comply with debt covenants or to preserve their reputation in the eyes of creditors. These findings reinforce the notion that a debt-dominated capital structure can deteriorate the quality of financial reporting, as also documented by Chen et al. (2023). Moreover, prior studies highlight that corporate governance mechanisms such as board independence, audit committee effectiveness, and CEO power can condition this relationship by either constraining or facilitating earnings management practices (Alves, 2023; Kalembe et al., 2024).

From a capital structure standpoint, the negative association between leverage and profit quality can be interpreted through the trade-off theory. As leverage increases, the benefits of debt in the form of tax shields are gradually outweighed by higher bankruptcy costs and financial distress risks, which intensify managerial pressure. Consistent with this theoretical explanation, Kruk (2021) and Putri and Willim (2024) show that excessive leverage heightens financial risk and encourages earnings management as a means of masking performance weaknesses. Kartika et al. (2023) and Tanko (2025) further confirm that an unbalanced capital structure is associated with lower profit quality.

These findings can also be explained by the pecking order theory, which posits that firms prioritize internal financing, followed by debt and equity as a last resort. Excessive reliance on debt increases information asymmetry between managers and creditors,

thereby creating incentives for earnings manipulation. Consistent with this view, Islam et al. (2022) and Çam and Özer (2022) show that debt financing exacerbates information asymmetry, while Hsu and Yang (2022) and Lassoued and Khanchel (2025) document that managers respond by managing earnings to meet creditors' expectations.

Regarding the control variables, company size and sales growth are positively associated with profit quality. Larger firms benefit from stronger internal controls, greater resources, and stricter external monitoring, which limit accrual manipulation, as supported by Velte (2021) and Bisogno and Donatella (2022). Similarly, higher sales growth reflects stronger operational performance, reducing the need for earnings management because favorable economic outcomes are already captured in financial statements (Zalata et al., 2022).

These findings imply that excessive leverage increases the risk of opportunistic earnings management, underscoring the importance of maintaining an optimal capital structure and strengthening internal control and governance mechanisms. For investors and creditors, the results suggest that earnings information from highly leveraged firms should be interpreted with caution. Theoretically, this study supports accounting theory and capital structure theories by confirming that trade-off and pecking order mechanisms play a key role in explaining variations in profit quality.

CONCLUSION

The results indicate that higher leverage tends to erode profit quality, as increased debt pressure encourages greater managerial discretion and earnings manipulation, thereby weakening the reliability of financial reporting. In contrast, company size and sales growth are shown to have a positive effect on profit quality, suggesting that firms with larger operational scale and stronger sales performance are more capable of producing financial information that faithfully represents their underlying economic conditions. These findings underscore the importance of capital structure decisions in shaping the quality of financial reporting within the Indonesian manufacturing sector.

From a practical perspective, the results highlight the need for managers to maintain an optimal balance between debt and equity financing. Excessive reliance on debt may increase bankruptcy risk and reduce stakeholders' confidence due to declining reporting quality, whereas greater use of equity can help firms structure their capital more conservatively and enhance transparency. For investors, the negative association between leverage and profit quality suggests that firms with relatively high debt levels should be assessed with greater caution, particularly in evaluating the credibility of reported earnings and overall financial performance.

Despite its contributions, this study has several limitations. The analysis is confined to Indonesian manufacturing firms and the 2015–2024 period, which may limit the generalizability of the findings across sectors and over longer economic cycles. In addition, the use of the Arellano–Bond GMM estimator may not fully capture the complexity of the relationship between capital structure and profit quality. Future research could extend the analysis to non-manufacturing sectors, such as services or financial institutions, and apply alternative estimation approaches, including System GMM or Bayesian models, to provide more robust and comprehensive insights under different market conditions.

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