# The Disclosure Tone, Earnings Management, Earnings Quality: Evidence Found in Indonesia Listed Manufacturing Industry

Saarce Elsye Hatane[a)], Gabriella Gunawan[b)], and Oviliani Yenty Yuliana[c)]

*Petra Christian University*
*School of Business and Management*
*Siwalankerto 121-131, Surabaya 60236, Indonesia*

[c)] Corresponding author: oviliani@petra.ac.id
[a)] elsyehat@petra.ac.id
[b)] d21220036@john.petra.ac.id

**Abstract.** To further analyze the relationship between Earnings Management (EM), Earnings Quality (EQ), and the Disclosure Tone (DT) of the Indonesian manufacturing industry. Furthermore, NVivo's coding AI measures the DT through automated text analysis. The sample of 61 listed Indonesian manufacturing enterprises from the years 2017 to 2021 is tested using panel data analysis. It has been discovered that EM has a significant positive association with DT, and EQ has an insignificant negative association. This study found that the asymmetric information makes the companies to increase positive and negative tones in their annual report. Additional variables and samples will need to be added to assess the industry in future studies to provide a more in-depth examination of DT's influence.

## INTRODUCTION

In reality, businesses are pressured to portray steady long-term economic growth and to have inclined earnings to show their business profitability. By understanding the nature of companies in emerging markets in Indonesia, it's impossible to have smooth incline earnings due to instability nowadays with all the endless uncertainty influenced by political, sociocultural, and technological changes. Through this uncertainty and competitive market situation, a firm's management is required to manage its earnings with the right strategy to gain the most significant result for the firm. From a practical standpoint, Indonesia, as an emerging market, relies on several businesses to supplement its national economic income.

As one of the key players, state-owned enterprises in the manufacturing industry (Kemenperin, 2022) are reported to have a decline in their income, yet the firm can show positive earnings in 2021, as reported by Bisnis.com. This example shows how firms manage their earnings through earning management. Earning management is a legal way to manage a business's earnings. But it can become illegal if they have high discretionary accruals compared to their non-Discretionary accruals in their earnings. The measurement method to prove this is where we can check the company's earnings quality.

Discretionary accruals are the portion of overall accruals that impact the result of earnings quality. Earnings are indeed a crucial component of the financial report and are used to aid management in setting business strategies. Disclosure tone is one of the corporate story disclosure qualities. In addition to positive and negative words, disclosure tone now contains qualities such as unsure, controversial, and strong modal tones, as well as sub-categories including commendation, pleasure, guilt, and rejection.

The disclosure tone in business descriptions is primarily intended to be educational, conveying management's perspective on the businesses' present and future performance to consumers. On the other hand, narrative or qualitative disclosures have recently acquired traction, making for a considerable amount of annual business information. The increasing essentiality of descriptive disclosure compared to reviewed monetary accounts prompted this research. Discretionary narratives are narrative disclosures that are included in unregulated areas of corporate paperwork that go beyond audited financial reports.

Most study into disclosure tone manipulation has remained in developed markets. This research aims to look at the company's Earnings Quality to help external stakeholders and investors have an improved knowledge of the company's earnings quality and then safeguard them from any manipulation that the corporate's management may do. Despite these changes, Indonesian businesses are challenged to improve corporate disclosure and protect investors. The circumstances of Indonesia as a growing market inspired this research on how disclosure tone affects earnings management and quality.

Similarly, through this research, we are trying to look at the likely impact of those indicators mentioned above. This study attempted to improve and conduct a more in-depth analysis based on empirical research in Indonesian corporate firms, emphasizing publicly listed manufacturing firms. As a developing country, Indonesia has tremendous opportunities to grow as a government through bilateral and regional agreements, opening up new opportunities for entrepreneurs, individual workers, and corporate firms. As a result, each party must concentrate more on understanding and developing an excellent corporate strategy at each level.

## LITERATURE REVIEW

### Earnings Management

Earnings Management (EM) arises when individuals utilize their discretion in financial statements and transactional structure to manipulate financial reports in order to deceive certain stakeholders regarding the firm's actual financial outlook or to affect results and evaluations that rely on the financial performance of the firm (Healy & Wahlen, 1999).

Through EM conduct, managers of a company could utilize that data to leverage the corporation's earnings, resulting in an improved corporate's performance that external parties will see. This kind of practice is not protecting the company's existing shareholders, and at the same time, it is also deceiving the public, for example, in the case of Enron. Indeed, we can see if the scenario in the previous sentence is implemented, that means management is doing it only for their own personal benefit and not for the rest of the stakeholders in the corporations (Karpoff,2021).

H1: There is an association between earnings management and the disclosure tone of the listed Indonesia Manufacturing Industry.

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### Earnings Quality

The grade to which a business's financial records precisely depict income for that period, for example, by only showing actual sales made during that period and excluding money that may not be reproduced in the future, is referred to as earnings quality (Abou-El-Sood & El-Sayed, 2022). The trustworthiness and legitimacy of a company's stated earnings are referred to as earnings quality. Investors view the earnings report as containing data to examine the Ownership shares. Quality Earnings are profits that might represent long-term earning potential as decided by accrual and cash, the future components, and display the business's actual financial performance.

Earnings quality also serves as the caliber of financial data. Consequently, the preceding concept of Earnings quality only when seen in the context of decision models (Hasanuddin,Taufan,Salim, Putra, 2021) . The initial category consists of earnings consistency, the size of accruals, residual model accrual, and Smoothness of earnings. In addition, the presence of earnings management by the agent or the connection between the agent and principal that is detrimental to the financial statement user might indicate that a moral hazard is present.

A strong indicator of lower earnings quality would be the existence of earnings management. When a manager chooses an accounting system or a policy, they have the option of managing earnings. However, this choice may impact earnings or the accomplishment of specific managerial statement goals. Empirical evidence suggests that the existence of earnings manipulation could be utilized to examine the effectiveness of earnings. Three proxies were employed by Calabrò, Cameran, Campa, and Pettinicchio 2020) to gauge the quality of earnings. In the sense that reported profits give information about a firm's long-term sustainability and are also closely connected to a company's cost of capital, earnings correctness is one of the essential elements influencing a firm's sustainability.

H2: There is an association between earnings quality and disclosure tone of the listed Indonesia Manufacturing Industry.

## Disclosure Tone

Disclosure tone is the tone of the annual report or information, or data publicly shared by the corporation, such as annual press releases and annual reports. According to initial disclosure theory, corporations are compelled to reveal all material information because of the classic unwinding result (Grossman, 1981; Milgrom, 1981). As a result, initial disclosure theory postulates that capital markets have no information problems. These disclosure models typically presumptively consider. Shareholders are informed that a company has material thanks to free disclosures. 1983's Verrecchia and Dye (1985) reject these presumptions to develop a theoretical framework for studying company communication. A rising body of experimental studies in the field demonstrated a variety of factors that influence disclosure decisions (Fuller, Joe, and Luippold, 2021). Firm size is frequently influencing disclosure decisions (Alshirah, Alshira'h, and Lutfi, 2021). Earnings, a need for external funding (Lang & Lundholm, 1993), as well as risk characteristics like the risk of bankruptcy, operational risks, and systematic risk (Monjed, Ibrahim, and Jorgensen, 2022) are also known to influence disclosure decisions. Recent research has also revealed several corporate governance variables that affect transparency.

Managers frequently exercise discretion to highlight the success of their companies. In their examination of disclosure practices prior to experienced equity offers, Lang and Lundholm (2000) concluded that administrators "hype" the firm's shares through swelling unrestricted disclosure, mainly positive disclosures. In cases when the market has a more challenging time spotting misrepresentation, administrators tend to skew the income estimates, according to Rogers and Stocken's 2005 study. Zechman (2010) offers proof that businesses purposefully withhold information on off-balance sheet activities when it was carried out to improve the presence of financial information, but not otherwise. Li (2010) discovers evidence to provide the idea that administrators hide subpar outcomes by making publications that are harder to understand.

Evidence suggests that these discretionary disclosure decisions impact investors' and analysts' perceptions. For instance, rising stock prices prior to share offerings are linked to the rise in positive disclosures noted by Lang and Lundholm (2000). Similarly, the degree of confidence in an income statement is favorably associated with the announcement's immediate impact on the market. A similar relationship embraces evidence produced by the company for SEC filings (Loughran and McDonald 2011) as well as information produced by third parties; Tetlock et al. (2008) and Tetlock (2007) discover that revenues are associated with the tone of news stories about the company and more generally.

Although previous findings have both statistical and economic significance, this study also agrees with Loughran and McDonald (2011, 53) that textual research is enough to solve the returns riddle. In other words, litigation risk is not only determined by disclosure tone, and litigation risk is not the only cost or benefit that should be considered when choosing disclosure tone. The fact that management has control over a tone of disclosure and that it is related to the danger of a lawsuit, in our opinion, is what's most important.

Even though there have been numerous essential studies on disclosure tone, there has been very little research on how corporate earnings management, earnings quality, and disclosure tone are associated. According to Tucker (2015), managers have more control over disclosure tone than they do over numerical reporting. Both boards of directors and chief executive officers should decide on the disclosure tone, according to Patelli and Pedrini (2015). They contend that one crucial approach for directors to demonstrate leadership is the tone of the CEO letters. Additionally, they offer empirical proof that resolute, challenging, and uninteresting language is positively associated with aggressive financial reporting. According to Bozzolan, Cho, and Michelon (2015), the management of the Fiat Group strategically employs several disclosure techniques with varying degrees of salience and optimism to interact with diverse stakeholders (such as the local press, the foreign press, and financial analysts). One question arises after knowing the previous study: Does any association between Earnings Management and Earnings Quality to Disclosure Tone become the core foundation of this study?

## RESEARCH METHODOLOGY

### Theoretical Model

As this study includes numerous variables, a multiple linear regression model is employed to gauge the relationship between the independent and dependent variables. The following formula is the representation of the regression model:

$$TONE_{it} = \alpha + \beta_0\ EM_{it} + \beta_1\ EQ_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4\ AGE_{it} + \beta 5\ MTB_{it} + \varepsilon_{it}$$

with the following explanations:

| | | |
|---|---|---|
| $TONE_{it}$ | = | Net tone score in the earnings press release of company *i* in time *t* COMPANY *i* in time *t* |
| $EM_{it}$ | = | Net income before extraordinary items scaled by beginning total assets |
| $EQ_{it}$ | = | Earnings smoothness of firm (*i*) in year (*t*) |
| SIZEit | = | Firm size of company *i* in time *t* |
| LEVit | = | Firm leverage of company *i* in time *t* |
| AGEit | = | Log (1 + age from the first year the firm listed in IDX) |
| MTBit | = | Market to book of company *i* in time *t* |
| εit | = | Error of company *i* in time *t* |
| α0 | = | Constant of the linear regression |
| β1-7 | = | Regression coefficient of each variable |

### Sample and Data

This research covers samples from manufacturing firms, particularly in the basic industry and chemical sector, Miscellaneous sub-sector, and consumer goods. As a result, 61 firms fit the purposive sampling criteria. Further, this study will cover a five-year period which results in 305 firm years (61 firms x 5 years) of firm annual reports from Indonesian publicly listed manufacturing corporations.

### Measures

The data obtained and utilized for the study are further explained below.

*Disclosure Tone*

This study uses the NVivo application's automated analysis (Hilal and Alabri, 2013) to analyze the annual report's descriptive narratives. In addition, this study makes use of automated text analysis. The discrepancy between both the number of optimistic and bad words, divided by the total number of positively and negatively words, is used to create net tone scores (net optimism scores):

- TONEi,t = net tone score in the annual report of the firm in year (*t*)
- PWi,t amount of positive text in the annual report of firm (*i*) in year (*t*)
- NWi,t = amount of negative text in the annual report of firm (*i*) in year (*t*)

$$TONE_{i,t} = \frac{PW_{i,t} - NW_{i,t}}{PW_{i,t} + NW_{i,t}} \tag{1}$$

*Earnings Management*

DA remains utilized as the benchmark for EM to align with the net tone disclosure benchmark (discretionary part of tone). Discretionary accruals are estimated using the Modified Jones Model (Dechow et al., 1995) as follows for each industry combination and each year:

$$TACCi,t\ =\ b0\left(\frac{1}{Ai\ t-1}\right) + b1\left(\frac{\Delta REVi,t - \Delta REVi,t}{Ai\ t-1}\right) +\ b2\left(\frac{PPEi,t}{Ai\ t-1}\right) + ei,t \tag{2}$$

| | |
|---|---|
| TACCit | = total accruals of company (1) in year (t). |
| Ai t-1 | = lagged total assets of firm (1) in (t-1). |
| AREVit | = Alteration in company (t) SR from year (t-1) to year (t). |
| ARECit | = alteration in company (1) AR from year (t-1) to year (t). |
| PPELt | = gross property, plant and equipment of firm (1) in year (t). |

bo, bl, b2 = regression limitations to be projected.
Li = error tenure on behalf of the discretionary part of total accruals.

To mirror the usage of the exact amount of anomalous disclosure tone in this research, this study utilizes the exact number of DA, or the number of DA without taking into account the purpose to boost or reduce profits.

*Earnings Quality*

The concept of "earnings quality" is multifaceted, and numerous metrics can be used to measure its various aspects. Therefore, determining whether profits are of high or low value using a single statistic is inadequate. For instance, wages might be steady and foreseeable, but this will not ensure high-quality earnings. Menicucci (2019) stated that persistence might result from the company's interference or manipulation of the financial reporting process. Therefore, based on existing studies, we focus on four earnings quality proxies. We utilize a market-based measurement, a value significance of profits metric, and three bookkeeping metrics of earnings quality (income smoothness, consistency, and predictability). Dechow et al. determined the following criteria for measuring earnings smoothness:

$$Smoothi,t = \frac{\sigma\,(EARNi,t\ /\ Ai\ t-1)}{\sigma\,(CFPi,t\ /\ Ai\ t-1)} \tag{3}$$

*Firm Size*

Firm Size explains the total scale or volume of operation turned out by a firm. The more significant number of a firm's total assets indicates a greater number of firm sizes. Here is the firm size proxy as follow:

$$\text{FirmSize} = \text{Log (Total Assets)} \tag{4}$$

*Firm Leverage*

Leverage represents the firm's financial risk and is usually expressed as a ratio of the total debt to total assets (Sultan et al., 2014; Samaha & Khlif, 2017).

*Firm Age*

Firm Age as the control variable in this context of the study presented in number explains the total period of the firm's operation year.

*Firm Value*

Market to book is the ratio utilized to measure firm value as the ratio of fair value equity to the book value equity. (Booth, Cleary, & Drake, 2014).

## RESEARCH RESULT AND ANALYSIS

### Descriptive Statistics

TABLE 1. Descriptive Statistics Analysis of Variables

| Variable | Mean | Median | Min | Max | Standard Deviation |
|---|---|---|---|---|---|
| Earnings Management | -0.004 | 0.011 | -2.087 | 0.810 | 0.227 |
| Earnings Quality | 1.310 | 0.523 | 0.008 | 23.479 | 2.489 |
| Disclosure Tone | -2.505 | -4.000 | -351.000 | 219.000 | 60.181 |
| Firm Leverage | 0.206 | 0.269 | 0.000 | 4.520 | 0.468 |
| Firm Size | 12.634 | 12.481 | 11.226 | 14.565 | 0.725 |
| Firm Age | 47.544 | 26.000 | 0.000 | 41.000 | 227.968 |

Source: Author research's compilation

Table 1 assists in explaining the Standard Deviation from each of variables as in accordance with the nature of Standard Deviation helps in showing the variability of data collected.

## Panel Data Analysis

TABLE 2. Weighted Least Square Result of Earnings Management

| Variable | Negative Tone | | Positive Tone | | Net Tone | |
|---|---|---|---|---|---|---|
| | Coefficient | P-value | Coefficient | P-value | Coefficient | P-value |
| const | −702.515 | <0.0001*** | −906.988 | <0.0001*** | 316.992 | 0.512 |
| Earnings Management | 22.084 | 0.0750* | 36.535 | 0.003*** | 16.894 | 0.537 |
| Firm Age | −65.979 | <0.0001*** | −87.983 | <0.0001*** | −57.554 | 0.095* |
| Firm Size | 85.097 | <0.0001*** | 103.459 | <0.0001*** | −19.387 | 0.625 |
| Firm Leverage | −3.356 | 0.833 | −12.628 | 0.327 | −11.161 | 0.174 |
| Firm Value | 2.413 | 0.0378** | 4.308 | <0.0001*** | 0.111 | 0.915 |
| Adjusted R-squared | 0.532 | | 0.648 | | 0.033 | |
| P-value(F) | 1.99e-48 | | 1.02e-66 | | 1.04e-22 | |

Source: Author research’s compilation

TABLE 3. Weighted Least Square Result of Earnings Quality

| Variable | Negative Tone | | Positive Tone | | Net Tone | |
|---|---|---|---|---|---|---|
| | Coefficient | P-value | Coefficient | P-value | Coefficient | P-value |
| const | −725.116 | <0.0001*** | −144.276 | <0.0001*** | −144.276 | <0.0001*** |
| Earnings Quality | −0.753 | 0.601 | −0.165 | 0.840 | −0.165 | 0.840 |
| Firm Age | −33.085 | 0.014** | −11.906 | 0.002*** | −11.906 | 0.002*** |
| Firm Size | 83.821 | <0.0001*** | 12.481 | <0.0001*** | 12.481 | <0.0001*** |
| Firm Leverage | −3.602 | 0.830 | −5.247 | 0.297 | −5.247 | 0.297 |
| Firm Value | 2.547 | 0.051* | 0.912 | 0.129 | 0.912 | 0.129 |
| Adjusted R-squared | 0.540 | | 0.604 | | 0.083 | |
| P-value(F) | 2.03e-49 | | 4.22e-59 | | 9.53e-06 | |

Source: Author research’s compilation

The findings from Table 2 shows the R-squared value shows the amount of 0.648. It can be interpreted that the independent variable of this result can explain the dependent variable of DT. Based on the weighted least square result in Table 2, it can be observed that 5 out of 6 independent and control variables have a significant association with the dependent variables of DT. It is shown that the p-value is less than 1%. The result of less than 1% suggests enough indication to reject the null hypothesis and accept the research premise. Meanwhile, the R-squared value shows the amount of 0.532. It can be interpreted that the independent variable of this result could clarify the dependent variable of DT. The findings from Table 2 demonstrate that Earnings Management (EM) has a good association with both positive and negative tones. Because the net tone is the sum of the positive and negative tones, this could prevent Earnings Management from impacting the net tone. Positive EM's influence on positive and negative signals shows that it is impossible for EM to control the net tone of the financial statements, either by raising the positive tone or lowering the negative tone.

Whereas the findings from Table 3 demonstrate that Earnings Quality (EQ) positively affects both positive and negative tones. Because the net tone is the sum of the positive and negative tones, this could prevent the EQ from impacting the net tone. Positive EQ's influence on positive and negative signals shows that it is impossible for EQ to control the net tone of the financial statements, either by raising the positive tone or lowering the negative tone.

## DISCUSSION AND ANALYSIS

This research focuses on investigating the relationship between Earnings Management and Earnings Quality and Disclosure Tone. This study has been performed using panel regression based on a fixed effect model on 61 manufacturing companies in Indonesia that have been publicly listed on Indonesia Stock Exchange from 2017-2021.

H1: There is an association between earnings management and the disclosure tone of the listed Indonesia Manufacturing Industry.

Table 4 shows that the H1, which is Earnings Management is associated with Disclosure tone (Net Tone), has an insignificant effect on manufacturing companies in Indonesia. This study further analyzes the data separately to study the association of EM with positive and negative tones. As we can see from Table 5, EM has a positive association (36.535) at 0.001% level to Positive tone, which means if there is EM in the company, the positive tone written in the text published inside the annual report also increases. Also, in Table 6, we can see that Earnings Management also has a positive association (22.084) at 0.001% level to Negative Tone, which means if there is EM in the company, we can see the negative Tone in the descriptive text of the annual report also increases. Therefore, the first hypothesis of this study is supported. This outcome is constant with the previous research by El Sood (2021), which showed that there is a positive association (0.811) between EM to Tone at a significant 10% level.

This research looked at the outcomes of this study to imply that when EM, as measured by the extent of discretionary accruals, grows, so does the quantity or degree of disclosures in annual data narratives. According to El-sood (2021), this outcome supports the hypothesis that tone management—i.e., intentional accumulation of tone—can be used by management to complement earnings manipulation in narrative disclosures. Moreover, it is consistent with how agency theory understands the "Opportunistic Viewpoint" of the abnormal disclosure tone. In this sense, the data offer preliminary proof that managers may also control the textual disclosures accompanying these controlled earnings numbers if they use income smoothing techniques. As a result, manipulating corporate narratives' tones (abnormally high degrees of exposure) can be used to determine whether management practices like earnings management are possible.

H2: There is an association between earnings quality and disclosure tone of the listed Indonesia Manufacturing Industry.

Firm size has an impact on firm value. As the results portrayed in Table 4, there is a negative association (-144.276) at 0.001% level between Earnings Quality (EQ) and Net Tone. This study further analyzed the relationship between the variables separately to positive and negative tones. As we can see from Table 5, there is a negative association (-850.461) between EQ and positive tone, while from Table 6, we can see a similar association which is a negative association (-725.116) between EQ and negative tone at 0.001%. Therefore, H2 is supported. It is consistent with previous study conducted by El-Sood (2021) that stated there’s a significant association between tone and earnings smoothness (the proxy of EQ). It shows that quality alteration in a company’s descriptive disclosure could be utilized as a gauge of the quality of its earnings, as determined by the smoothness of those earnings. The findings are consistent with previous studies from developed countries that used textual features such as negative tone and readability (Li, 2010) to evaluate the quality of enterprise profitability.

## CONCLUSION, LIMITATION, AND RESEARCH CONTRIBUTION

This research aims to discover the relationship between Earnings Management and Earnings Quality and the disclosure tone in annual reports issued by a sample of Indonesian enterprises listed on the Indonesia Stock Exchange. Similarly, agency theory and the opportunistic or image management framework investigate whether a corporation uses tone in its narrative disclosures to promote its opportunistic behavior while employing EM. It mainly analyzes if the disclosure tone levels in firms' narrative disclosures are connected to firm EM and EQ in the setting of a developing market. The data show that disclosure tone levels in the narratives of annual reports of Indonesian manufacturing businesses are positively connected with EM, as measured by the size of DA.

This finding implies that manipulating the tone of corporate narratives as part of anomalous disclosure tone levels can be a valuable addition to earnings management techniques. It bolsters the agency theory's interpretation of the atypical disclosure tone from an opportunistic standpoint. Results indicate that organizations' management may employ a narrative disclosure tone to support the managed figures if they use earnings management tactics. We also investigate the association of Earnings Quality with disclosure tone.

In contrast to the relation of EM to tone, Earnings Quality has an insignificant negative association with disclosure tone. As a result, the body of data proposes that the degree of DT could be utilized to indicate the AR-qualifying firm's profitability. Concerning the recommendation, the study proposes BOD and auditors ought to be mindful of management's desire to employ atypical manipulative methods to justify their EM. While for Market players, especially amateur investors who might base their decisions on the narrative parts, need this study more than anyone. The findings increase their understanding of a company's authority over particular textual aspects in business reports, as well as the ability of managers to use narrative disclosure to impact investors' attitudes deliberately. As a result, this study advises consumers to consider various information sources when making decisions. Our findings also highlight the need for laws and guidelines that govern how corporate narrative information is disclosed. Governments and regulators should also examine the broader impact of their actions while enacting regulations because the effect could go beyond the main objective.

This research is subject to various limitations during the research. Further researchers who want to perform an in-depth study on the issue of EQ, EM, and DT are expected to use these limits as a preliminary for their own study on the subject. DT can be affected by a multitude of factors beyond the internal and external factors listed in this research. With this increasing complexity and uncertainty in the world, future research may use other DT characteristics, business segmentation, or financial components to study its impact on DT. Future research may try to investigate the factors influencing DT in another specific sector to obtain a more detailed understanding of the factors driving DT. This research only focuses on the factors influencing DT within the four years of 2017-2021.

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