The role of earnings quality in the impact of earnings management and leverage on firm value

Jouzar Farouq Ishak
Politeknik Negeri Bandung, Indonesia
jouzar.farouq@polban.ac.id

Abstract

Purpose: This study examines the impact of earnings management and leverage on firm value with earnings quality as an intervening variable.

Research methodology Quantitative methods were used in this study, which employed path analysis to examine the relationships between variables. Samples were taken from state-owned enterprises in Indonesia, with a particular focus on those listed on the 2017-2021 BUMN 20 Index of the Indonesia Stock Exchange.

Results: The results show that earnings quality mediates the relationship between leverage and firm value. Specifically, leveraging through earnings quality was found to maximize firm value, as profitable businesses prioritized internal financing because of their high rate of return.

Limitations: This study was limited to the IDX BUMN 20 index between 2017 and 2021.

Contribution: The findings suggest that management should consider leveraging to optimize firm value. In addition, it provides valuable insights into firm value, particularly for firms that rely heavily on internal financing.

Novelty: This research is the first study to specifically focus on the IDX BUMN 20 index, covering both the periods before and during the Covid-19 pandemic.

Keywords: *Earnings management, Leverage, Earnings quality, Firm value*

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1. Introduction

The capital market plays a crucial role in the business world and serves as an indispensable tool for a firm. Furthermore, it provides the necessary infrastructure and mechanisms to raise funds and to access investment opportunities. Without a well-functioning capital market, a firm looking to go public faces significant hurdles in its operations (Mubyarto & Khairiyani, 2019). Given the importance of the capital market, it is essential to conduct a comprehensive evaluation before making any investment. This evaluation aims to determine the profitability of potential investments and identify the factors that may impact a firm's future performance (Mudjijah, Khalid, & Astuti, 2019). One of the key aspects of the analysis is the assessment of firm value as it reflects the overall prosperity of shareholders.

A commonly used indicator to evaluate a firm's value is the Price to Book Value (PBV), which estimates future capabilities based on favorable prospects influenced by stable market price fluctuations (Siladjaja, 2021). This indicator measures the relationship between a firm's stock price and book value. A higher PBV indicates greater firm value (Khairiyani, 2018), suggesting that investors have higher expectations for the firm's future prospects. The primary objective of a corporation is to enhance shareholder prosperity by increasing its firm value (Siregar, Dalimunthe, & Safri, 2019). The PBV

correlates stock price with book value, and a lower PBV suggests greater affordability. In terms of affordability, a lower PBV suggests greater affordability, with the Rule of Thumb considering a PBV ratio below one as an indication of a cheap stock.

Research related to earnings management, earnings quality, and firm value has been conducted by (Beyer, Guttman, & Marinovic, 2019; Chen, Gotti, Herrmann, & Schumann, 2016) who found a positive relationship between earnings management and earnings quality. In contrast, (Anjum, Saif, Malik, & Hassan, 2012; Hermawan, Biduri, Hariyanto, & Ningdiyah, 2019) found that earnings management has a negative effect on earnings quality. Additionally, (Li et al. (2018) and Zurriah and Sembiring (2020) discovered that earnings management negatively affects firm value. Conversely, (Gao and Zhang (2015), Lizińska and Czapiewski (2018), and Riswandi and Yuniarti (2020) find a positive influence of earnings management on firm value. Regarding earnings quality and firm value (Mabruroh et al., 2015; Rokhayati et al., 2021), earnings quality has a positive and significant influence on firm value. However, study performed by Fitria (2019) found that earnings quality does not affect firm value.

Furthermore, studies related to leverage, earnings quality, and firm value were conducted by Kartikasari and Merianti (2016), who found a positive effect of leverage on earnings quality. However, other studies have reported different results. (Angelita and Sihombing (2019) and Fransisca and Widjaja (2019) suggested that leverage had a negative effect on earnings quality. Fitria (2019), Rashid and Saeed (2017), Rokhayati et al. (2021; Sienatra, Sumiati, & Andarwati, 2015; Syura, Arfan, & Anzib, 2020) concluded that leverage affected firm value. However, some studies have presented different conclusions. (Boubaker, Chourou, Saadi, & Zhong, 2019; Zurriah & Sembiring, 2020) found that leverage did not have a significant impact on firm value.

Previous research on earnings management, earnings quality, and firm value has yielded inconsistent conclusions, necessitating further investigation of the role of earnings quality in determining firm value. Therefore, this study examines the direct and indirect effects of earnings management and leverage on a firm's value. Additionally, this study investigates the intervening role of earnings quality in the relationship between earnings management and leverage in firm value.. The results provide valuable insights for decision-making in state-owned firms planning to go public and serve as a reference for future research.

2. Literature review

Management possesses more comprehensive information about a firm than investors, enabling them to potentially exploit this advantage by presenting financial statements that do not accurately reflect the actual performance of the firm (Salim, 2015). To achieve specific profit targets, executives employ earnings management as a strategic approach by manipulating accounting policies (Scott 2015). However, this practice gives rise to agency problems between the principals and agents (Salim, 2015). One of the driving factors behind managers engaging in earnings management is profitability, which represents the financial gains generated by a firm's activity (Hasibuan & Dwiarti, 2019). Lestari & Wulandari, 2019). Earnings quality, measured by profitability, serves as a metric for evaluating leadership effectiveness. Earnings management occurs when leaders deliberately select activities with cash flow implications in order to manipulate reported income (Agustina et al. 2018). In general, profitability serves as a valuable measure for assessing a firm's overall success (Hasibuan & Dwiarti, 2019).

The relationship between profitability and earnings management arises when a firm seeks to enhance its reported revenue to attract and retain investors, based on the profitability achieved in a specific period (Hasibuan & Dwiarti, 2019; K. C. Lestari & Wulandari, 2019). Previous research has examined the association between earnings management and earnings quality. Beyer et al. (2019) and Chen et al. (2016) reported a positive impact of earnings management on earnings quality, while Anjum et al. (2012) and Hermawan et al. (2019) found a negative relationship between these two variables.

One of the dominant factors in financing a firm is leverage (Putra & Subowo, 2016), which refers to how a firm finances its assets through leverage, equity, or a combination of both (Fahcrian & Hidayat, 2023). Within a firm, leverage can give rise to an agency conflict between managers and shareholders (Yasa, Wirakusuma, & Suaryana, 2020). The level of leverage indicates a firm's capacity to meet short-term obligations, manage long-term debt, and maintain control, as it serves as a mechanism to mitigate opportunistic management (Nariman and Ekadjadja, 2018). Furthermore, the extent of debt utilization influences firm leverage (Wibowo and Wartini, 2012).

A firm obtains funds from both internal sources such as depreciation and retained earnings, as well as external sources through debt and share issuance (Octaviany, Hidayat, & Miftahudin, 2019). However, excessive reliance on debt financing is generally considered detrimental to firm profitability (Sari and Abundanti, 2014). Regarding the relationship between leverage and earnings quality, Kartikasari and Merianti (2016) identify a positive relationship between the two variables, while Angelita and Sihombing (2019) and Fransisca and Widjaja (2019) suggest a negative association.

Competitor performance can act as a trigger for earnings management, as investors and creditors compare a firm to assess its favorable ratings (Pernamasari & Mu'minin, 2019). Earnings management is used to increase firm value by artificially boosting profits, which is perceived as positive news (Riswandi and Yuniarti, 2020; Zurriah and Sembiring, 2020). When investors observe widespread earnings management among issuers, they may anticipate higher risk and demand greater returns on shares (Pernamasari and Mu'minin, 2019).

Managers' earnings management has the potential to significantly impact a firm's value. This enables management to manipulate the reported performance of a firm, making it appear higher or lower than its actual performance in a given year (N. Lestari & Ningrum, 2018; Li et al., 2018; Zurriah & Sembiring, 2020). Previous research suggests that earnings management negatively affects firm value (Gao & Zhang, 2015; Lizińska & Czapiewski, 2018; Riswandi & Yuniarti, 2020), whereas others indicate a positive relationship between these two variables.

Leverage refers to a corporation's ability to effectively manage its assets and funds by incorporating debt to achieve the goal of increasing the prosperity of owners and investors (Yusmaniarti et al., 2020). It is a ratio that quantifies a firm reliance on debt financing (Soerzawa, Yusmaniarti, & Suhendra, 2018). Leverage serves as an additional source of funding for a firm to finance its assets alongside capital funds (Firmansyah, Mardani, & Khalikussabir, 2020). However, excessive reliance on debt carries risks and can be detrimental to a firm, leading to extreme leverage, where the business is burdened by significant debt that is difficult to alleviate (Octaviany et al., 2019).

The size of leverage significantly affects firm value, emphasizing the need for effective management as excessive debt utilization can enhance firm value (Yusmaniarti et al., 2019). Evaluating the value of a corporation must encompass social and environmental aspects alongside financial considerations (Zulaecha & Murtanto, 2019). Firm value is of utmost importance, as it corresponds to improved shareholder prosperity, higher share prices, and overall business value (Zurriah & Sembiring, 2020). Leverage serves as an indicator of inherent risks in a corporation, with higher leverage levels being associated with increased investment risk (Yusmaniarti et al., 2019). Studies conducted by Fitria (2019), Rashid and Saeed (2017), and Rokhayati et al. (2021), Sienatra et al. (2015), andconfirm al. (2020) confirmed the iact of leverage ona firm value, w (le (Boubaker et al., 2019) and Zurriah suggestring (2020) suggested a lack of significant influence.

Profitability serves as a key indicator of the success of a firm (Ramdhonah, Solikin, & Sari, 2019). It significantly influences a firm's value by measuring its performance through the generated profits (Octaviany et al. 2019; Sari and Abundanti 2014). High profitability indicates the corporate ability to generate substantial returns for investors, thereby impacting firm value (Sutama & Lisa, 2018). Greater profitability is associated with higher firm value and inspires investor confidence in a business (Dewantari et al., 2019).

Furthermore, high profitability signifies strong performance and future potential, leading investors to perceive it as a positive signal and purchase shares (Kusumawati & Rosady, 2018). The success of a corporation in achieving growth and generating profits attracts investor attention and encourages investment (Rivandi and Septiano, 2021). Research conducted by Mabruroh et al. (2015) and Rokhayati et al. (2021) shows that earnings quality has a positive impact on firm value.

The proposed hypotheses regarding the relationship between earnings quality and firm value are as follows.
H1: Earnings management has a significant and positive impact on firm value.
H2: Leverage has a significant and positive effect on firm value.
H3: Earnings management has a significant and positive impact on earnings quality.
H4: Leverage has a significant and positive effect on earnings quality.
H5: Earnings quality has a significant and positive impact on firm value

3. Research methodology
This research is classified as a quantitative study because it relies on secondary data obtained from public companies listed on the BUMN 20 Index (IDX BUMN 20) of the Indonesia Stock Exchange (IDX) for the period from 2017 to 2021. The study falls under the category of explanatory research, which aims to analyze the relationship between variables (Sekaran & Bougie, 2016). The sample was purposefully selected by focusing on a consecutive state-owned firm listed on the IDX BUMN 20 from 2017 to 2021. Furthermore, the selection was carried out through purposive sampling, considering a firm that had published annual reports on its official websites and provided the necessary data requirements.

In this study, the independent variables are earnings management and leverage. Earnings management was evaluated using discretionary accruals, specifically the modified Jones model (Lento, Cotter, & Tutticci, 2016; Riswandi & Yuniarti, 2020). The second independent variable examined was leverage, which assesses the extent of debt financing for a firm's assets (Liviani & Rachman, 2021). Furthermore, the debt-to-equity (DER) ratio was employed as the leverage indicator, representing the ratio of Debt to Equity in the financial structure of a firm. The DER ratio has been used in studies by Fransisca and Widjaja (2019) and Sienatra et al. (2015).

Additionally, this research focused on examining firm value as the dependent variable, specifically utilizing the price-to-book value (PBV) ratio (Mabruroh et al., 2015; Villanueva-Villar, Rivo-López, & Lago-Penas, 2016). The PBV was calculated by dividing the market price per share by the book value per share. Earnings quality served as the intervening variable in this research and was represented by Return on Assets (ROA). ROA was used as a measure of profitability and overall success of a firm in generating the expected profit level. It has also been used in research by ENREF_23 and Rokhayati et al. (2021).

Moreover, this research specifically focuses on firms listed on the IDX BUMN 20 index, which serves as a significant benchmark for investors to assess market movements and evaluate their investment portfolios. Firms included in the IDX BUMN 20 index are known for their strong fundamentals and performance. To address this research problem, path analysis was conducted using a program to test the direct or indirect effects of variables and draw conclusions. The path analysis involved two sub-structures, including sub-structure 1 for direct effects and sub-structure 2 for indirect effects.

4. Result and discussion
Using purposive sampling, 17 state-owned firms from the IDX BUMN 20 index were consecutively selected for the 2017-2021 period, resulting in a dataset of 85 observations. The descriptive statistics in Table 1 show that the earnings management variable has a mean of 0.0025 or 0.25%, with a standard deviation of 0.0121, indicating a deviation of 1.21% from the average. The minimum and maximum values for earnings management are − -0.0468 (-4.68%) and 0.0791 (7.91%), respectively. Conversely,

the leverage variable, measured by the debt-to-equity ratio, had an average value of 3.6643, indicating an average utilization of long-term debt of 366.43% compared to equity. The standard deviation of the debt-to-equity ratio was 3.5468, indicating a deviation of 354.68% from the average. In this study, the minimum and maximum values of the debt-to-equity ratios were 0.4166 and 17.07, respectively.

The measure of earnings quality, represented by return on assets, has an average value of 3.62. This indicates that for every Rp1.00 of a firm asset, Rp3.62 of profit was generated. The standard deviation of 3.546, which is smaller than the average, suggests a limited deviation in profit generation compared with the average return on assets. Regarding firm value, proxied by price-to-book value, the mean was 27.62. This signifies that on average, a firm has a market price per share to book value per share ratio of 27.62. However, the standard deviation of 135.86 for the price-to-book value indicates a significant variation above the average. This suggests a wide dispersion of values without distinct grouping.

Table 1. Descriptive statistics

| Variable	Min	Max	Mean	Std. Deviation
X1	-0.0468	0.0791	0.0025	0.0121
X2	0.4166	17.07	3.6643	3.5468
Y	0.06	22.25	3.6339	4.8293
Z	0.4283	1105.06	27.62	135.86

Source: Processed data (2022)

Table 2 displays the results of the inner model analysis, which aimed to ensure the robustness and accuracy of the developed structural model. In this analysis, the R-squared value was used as a measurement. The table indicates an R-square value of 0.284 for variables X1 and X2 to Y, emphasizing a combined effect of 28.4% for earnings management and leverage on earnings quality. This result implies that 71.6% of the variation in earnings quality is influenced by unexamined factors. Similarly, the R-Square value of 0.138 for variables X1, X2, and Y to Z suggests a collective effect of 13.8% for earnings management, leverage, and earnings quality on firm value. This implies that 86.2% of the variation in firm value can be attributed to other unanalyzed factors.

Table 2. R-Square

Variable	R-Square	
	Y	Z
X1, X2	0.284	
X1, X2, and Y		0.138

Source: Processed data (2022)

Path analysis was performed to examine the relationships between the variables. The first path analysis focused on Substructure 1, assessing the impact of the dependent variable. Subsequently, the second path analysis investigated Substructure 2, examining the effect of the independent variable on the dependent variable through the intervening variable. The research model, which depicts the data processing, is shown in Figure 1.

Dependent Variable   **Intervening Variable**   **Dependent Variable**

Earnings Management (X1)

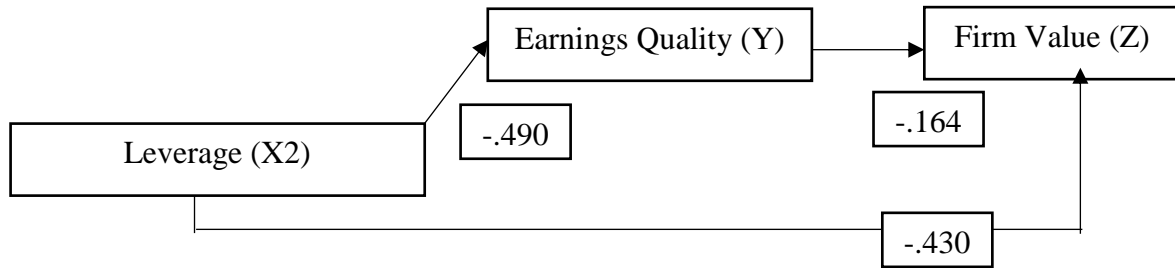.100   e1 = .993   -.160   e2 = .928
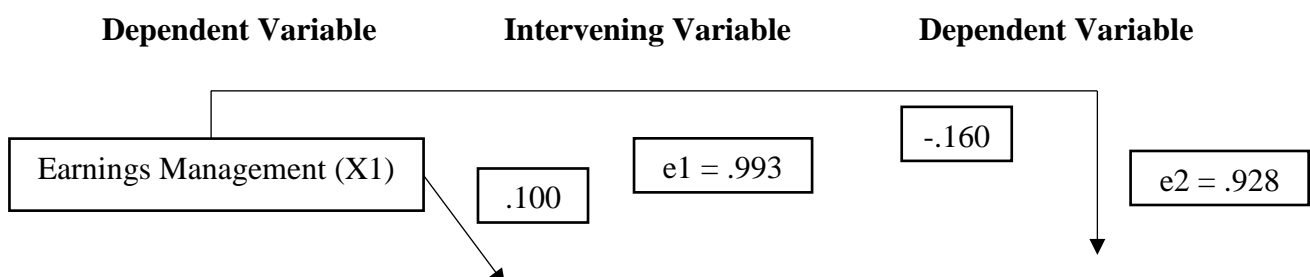
Figure 1. Research model
Source: Author (2022)

Table 3 shows that earnings management did not significantly impact earnings quality, as evidenced by a p-value of 0.315 and a standard coefficient beta value of 0.100. The likelihood of achieving desirable earnings quality is not influenced by earnings management. Notably, some firms engaged in earnings management in response to changes in earnings quality, whereas others did not. Certain corporations prioritize maintaining a consistent level of return on assets to ensure stable earnings quality. This finding contradicts those reported by Anjum et al. (2012) and Beyer et al. (2019), Chu et al. (2016), and Hermawan et al. (2019) suggest that EM has a significant impact of earnings management on earnings quality.

The statistical tests in Table 3 indicate that earnings management does not significantly affect firm value, with a p-value of 0.150, exceeding the threshold of 0.05. Furthermore, the standard coefficient beta value was -0.160, further supporting the lack of an impact. Thus, earnings management does not affect a firm's value. These results contradicted Gao and Zhang (2015), Lizińska and Czapiewski (2018), Riswandi and Yuniarti (2020), and Zurriah and Sembirisuggest (2018)irisuggest suggested a relationship between earnings management and firm value. The empirical evidence of this research does not support signaling theory, indicating that earnings management influences firm value through stakeholder responses.

Table 3. Substructure test result

Path	Std Coefficients Beta(β)	t count	P. value	Description
X1 ▸▸ Z	-0.160	-1.454	0.150	insignificant
X2 ▸▸ Z	-0.430	-0.3572	0.001	significant
X1 ▸▸ Y	0.100	1.011	0.315	insignificant
X2 ▸▸ Y	-0.490	-4.933	0.000	significant
Y ▸▸ Z	-0.164	-1.416	0.161	insignificant
t table =	1.99			
α =	5% = 0.05			
X1 =	Earnings management			
X2 =	Leverage			
Y =	Earnings quality			
Z =	Firm value			

Source: Processed data (2022)

The debt-to-equity ratio (leverage) exhibited a significant impact on earnings quality, as indicated by the p-value of 0.000 in Table 3. The standard coefficient value of beta was -0.490, suggesting a negative influence. Specifically, a 1% increase in leverage results in a -0.490 decrease in earnings quality. Therefore, leverage has a detrimental effect on earnings quality. The results of this study indicate that lower leverage utilization reduces firm costs associated with meeting its obligations, leading to improved profitability. This was attributed to the lower fixed costs related to interest expenses and loan principal repayments when relatively less debt was used. These results align with research that

highlights the negative impact of leverage on earnings quality (Angelita and Sihombing, 2019; Fransisca and Widjaja, 2019).

The results in Table 3 show that leverage has a negative effect on firm value. Furthermore, the computed t-value of -0.3572 exceeded the t-table value of -1.99, and the significance level (α) of 0.001 was less than 0.05, thus supporting the significance of the relationship. A regression coefficient value of -0.430 further supports the negative impact of leverage on firm value. This result aligns with trade-off theory, suggesting that achieving the optimal capital structure target led to a decrease in firm value when leverage was used. The introduction of debt brought about fixed costs unrelated to revenue, and a high leverage ratio signaled financial instability, resulting in a negative investor response and subsequent decline in firm value. These findings are consistent with research that also reports the influence of leverage on firm value (Fitria, 2019; Rashid & Saeed, 2017; Rokhayati et al., 2021; Sienatra et al., 2015). Notably, this result contradicts Boubaker et al. (2019) and Zurriah and Sembiring (2020).

The statistical test in Table 3 shows that earnings quality, as measured by the ROA proxy, does not significantly affect firm value (P-value = 0.161 > 0.05). This finding contradicts the signaling theory, proposing that information quality indicators positively impact stakeholders and enhance firm value. The study found no significant relationship between the revenue generated by a corporation and stock prices in the market. As a result, investors showed limited interest in firms with high PBV. These findings support Fitria's (2019) assertion that earnings quality does not exert a significant influence on firm value. Effective supervision and stakeholder response play a more critical role than earnings management actions when ROA accurately shows the actual situation. However, these findings contradict the viewpoints of Mabruroh et al. (2015) and Rokhayati et al. (2021), who argue for the influence of earnings quality on firm value.

Subsequently, the mediating variables were assessed to determine the indirect and total effects of the research variables. These measures assist in identifying the variables that influence firm value the most. Figure 1 illustrates the mediating role of earnings quality in the relationship between earnings management and leverage. This diagram indicates a direct effect of earnings management on firm value of -0.160. The indirect effect of earnings management on earnings quality was calculated as 0.100 x -0.164 = -0.064. Consequently, the total effect of earnings management on firm value is the sum of the direct and indirect effects, resulting in -0.160 + -0.064 = -0.224. It can be concluded that the indirect effect was smaller than the direct effect. This finding indicates that earnings quality does not significantly mediate the relationship between earnings management and firm value. Notably, this study had limited references, and no prior reviews have explored this topic.

The mediating role of earnings quality in the relationship between leverage and firm value is assessed in Figure 1. Leverage had a direct effect on firm value of -0.490, while its indirect effect on earnings quality was calculated as 0.070 (-0.430 x -0.164). Therefore, the total effect of leverage on a firm value was -0.420 (-0.490 + 0.070). These results indicate that earnings quality significantly mediates the relationship between leverage and firm value. Leverage strongly influences investors' operating profits. Hence, increased leverage enables a firm to use higher-value debt to impact share prices through the mediation of earnings quality.

5. Conclusion

In conclusion, this study investigated the factors influencing the value of state-owned firms in Indonesia, specifically those listed on the IDX. This study examines the variables of earnings management, leverage, and earnings quality. Their findings reveal that leverage has a negative impact on both earnings quality and firm value. This implies that increasing leverage has the potential to enhance a firm's value by serving as an indicator of its future business prospects. The research also highlights the mediating role of earnings quality in the relationship between leverage and firm value, emphasizing the importance of considering both factors when making investment decisions. These findings emphasize the need for management to be mindful of leverage to maximize firm value. Further,

this study offers valuable insights into firm value, particularly for firms with limited access to external financing.

5.1 Limitations and Research Forward

This study contributes significantly to the understanding of the factors that influence earnings quality and firm value. However, it is important to acknowledge the limitations of this study. First, focusing solely on state-owned firms in Indonesia may limit the generalizability of the findings to a broader target population. Future reviews should consider incorporating other indices, such as the composite index, lq45 index, or sector-specific indices, to create a more comprehensive model. Second, it would be beneficial to include additional factors that influence a firm's value, such as dividend policy, the earnings response coefficient, earnings presence, institutional ownership, and managerial ownership, to enhance the robustness of the model. Finally, model-fitting programs such as Lisrel and AMOS offer advantages over SPSS. These programs provide information on the overall fit of the model and insights into the total, direct, and indirect effects, thereby eliminating the need for manual calculations. Incorporating model-fitting programs enhances our understanding of model fit and its effects.

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