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The Influence of Earnings Management and Earnings Opacity on Firm Value with Corporate Governance Mechanism as a Moderating

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Abstract: This study investigates the impact of Earnings Management and Earnings Opacity on Firm Value, with Corporate Governance as a moderating factor. Firm Leverage and Firm Size are utilized as control variables to refine the analysis. The research comprises 304 observations from 76 consumer goods and agriculture companies listed on the Indonesia Stock Exchange between 2018 and 2021. Panel data regression analysis is conducted to test the hypotheses. Results reveal that Earnings Management and Earnings Opacity positively influence Firm Value. However, Corporate Governance does not enhance the relationship between Earnings Management and Firm Value. In contrast, Corporate Governance amplifies the impact of Earnings Opacity on Firm Value, underscoring the critical role of governance in mitigating the adverse effects of financial report opacity. This study enriches existing literature by examining the differential moderating effects of Corporate Governance on Earnings Management and Earnings Opacity. The findings offer valuable insights for corporate leaders, highlighting that robust governance and financial transparency drive sustainable performance and bolster investor confidence. By fostering transparency and accountability, companies contribute to market stability and public trust, especially in sectors vital to economic growth. Targeting specific sectors in emerging markets advances the understanding of financial reporting and governance dynamics.

Keywords: corporate governance, earnings management, earnings opacity, firm value, moderating effect.

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INTRODUCTION

In the modern business world, firm value has become one of the primary indicators reflecting the long-term welfare of company owners (Schoenmaker & Schramade, 2019). Firm value, as reflected in stock prices, represents investor expectations regarding the company's financial performance and growth prospects (Jensen & Meckling, 1976). Therefore, management holds the responsibility to maintain and enhance firm value efficiently and sustainably.

One phenomenon frequently observed in business practices is earnings management, where managers manipulate financial statements to meet specific targets or influence investor perceptions (Baskaran et al., 2020).

While this practice may enhance firm value in the short term, it carries the potential to generate information risks that could harm shareholders in the long run (Smulowitz et al., 2019). Previous studies have shown that earnings management practices in Indonesia tend to be higher than in other ASEAN countries (Leuz et al., 2003; Januarsi & Yeh, 2022). Ratmono (2010) also found significant indications of loss avoidance in the financial statements of publicly listed companies in Indonesia. This situation raises concerns about the integrity of financial reports and underscores the importance of implementing good corporate governance.

In addition to earnings management, earnings opacity also contributes to information risk (Andriani & Afriyenti, 2019). When companies report earnings that do not accurately reflect their true economic conditions, information risk increases, ultimately raising the cost of equity and exacerbating the relationship between managers and shareholders (Kothari, 2001).

In this context, corporate governance plays a crucial role in mitigating the negative impacts of earnings management and earnings opacity. The implementation of good corporate governance (GCG) aims to enhance corporate transparency, accountability, and responsibility, thereby reducing harmful financial manipulation practices (Rachmawati & Triatmoko, 2007). With an effective governance system, companies are expected to prevent conflicts of interest between management and shareholders and minimize information risks that could lower firm value (Khaoula & Moez, 2019).

Furthermore, factors such as firm leverage and firm size also significantly influence earnings management and firm value (Dang et al., 2019; Boachie & Mensah, 2022). Firms with high leverage levels are often under pressure to meet creditor requirements, increasing the likelihood of financial statement manipulation (Naftalia & Marsono, 2013; Lin et al., 2009). Conversely, larger firms are often associated with better accounting information systems and higher levels of transparency. However, in some cases, operational complexity may open opportunities for financial manipulation (Cornette et al., 2009; Liu & Lu, 2007).

Although numerous previous studies have examined the relationship between earnings management, earnings opacity, and firm value, certain research gaps remain unaddressed, particularly concerning emerging markets and the ASEAN context, earnings opacity, the moderating role of corporate governance, and the influence of firm leverage and firm size as control variables, specifically in the Indonesian context.

This study aims to obtain empirical evidence regarding the impact of earnings management and earnings opacity on firm value, with corporate governance as a moderating variable. Additionally, this research will examine whether firm leverage and firm size, as control variables, strengthen or weaken these relationships. The research questions include: 1) Do earnings management and earnings opacity influence firm value?; 2) Does corporate governance strengthen or weaken the effect of earnings management and earnings opacity on firm value?; 3) Does corporate governance moderate the impact of earnings management and earnings opacity on firm value with firm leverage and firm size as control variables?.

This study is expected to make significant contributions to academic literature and business practices, particularly in understanding the dynamics between financial statement manipulation, corporate governance, and firm value in emerging markets. Hence, the results of this research can serve as a reference for regulators, investors, and company management in efforts to improve the quality of financial reporting and corporate governance, as well as to facilitate better investment decision-making.

METHODS

This study employs a quantitative research design with a causal approach to explain the influence of Earnings Management and Earnings Opacity on Firm Value, with Corporate Governance as a moderating variable.

The sample consists of 76 companies from the consumer goods and agriculture sectors listed on the Indonesia Stock Exchange (IDX) between 2018 and 2021, resulting in 304 firm-year observations. This approach ensures a robust dataset for hypothesis testing.

The data analysis employs quantitative methods, specifically multiple linear regression analysis, to determine the effect of two independent variables on a dependent variable, moderated by one moderating variable. Panel data regression analysis is conducted to enhance the accuracy and reliability of the results.

In this study, moderated regression analysis is conducted to examine the effect of Earnings Management and Earnings Opacity on Firm Value, moderated by Corporate Governance, with Firm Leverage and Firm Size as control variables. The regression model developed is as follows:

$$FV = \beta_0 + \beta_1 EM + \beta_2 EO + \beta_3 EM*CG + \beta_4 EO*CG + \beta_5 FL + \beta_6 FS + e$$

Explanation:
FV = Firm Value
EM = Earnings Management
EO = Earnings Opacity
CG = Corporate Governance
EM*CG = Corporate Governance moderates the relationship between Earnings Management and Firm Value
EO*CG = Corporate Governance moderates the relationship between Earnings Opacity and Firm Value
FL = Firm Leverage
FS = Firm Size
$\beta 0$ = Constant term
$\beta 1, \dots, 6$ = Regression coefficients
e = Error

Dependent Variable (Firm Value): Firm Value is measured using Tobin's Q, a widely accepted proxy for evaluating firm performance and market valuation.

Independent Variables: Earnings Management is measured using the Non-Discretionary Accruals model, following the methodology of Dechow et al. (2011). This model differentiates accruals based on (i) accrual measurement and (ii) determinants of non-discretionary accruals. Non-cash working capital accruals (WC_ACC) serve as the standard measure across all models. Earnings Opacity is assessed using profit aggressiveness, as proposed by Bhattacharya et al. (2003).

Moderating Variable (Corporate Governance): The evaluation of Corporate Governance practices follows the International Standard Code on GCG developed by the Organization for Economic Cooperation and Development (OECD). This framework serves as a benchmark for assessing governance practices.

Control Variables: Firm Leverage is measured using the debt-to-equity ratio, calculated by dividing total debt by total equity. Firm Size is measured by the natural logarithm of total assets, as larger firms typically have greater access to capital markets and receive higher investor trust, contributing to positive market signals (Malau et al., 2019).

To test the research hypotheses, interaction terms between Corporate Governance and both Earnings Management and Earnings Opacity are introduced in the regression models. The analysis is conducted using statistical software to ensure the precision and reliability of the findings. Robustness tests, including heteroskedasticity-consistent standard errors and multicollinearity diagnostics, are conducted to validate the reliability and generalizability of the results.

RESULTS AND DISCUSSION

The data used in this study is cross-sectional over a specific period, characterizing it as panel data research. The appropriate model for panel data regression was determined using the Chow Test (Likelihood Ratio) to differentiate between the Common Effect and Fixed Effect models, the Hausman Test to decide between Fixed Effect and Random Effect models, and the Lagrange Multiplier Test to choose between Random Effect and Common Effect models.

Table 1 Chow Test Results

Effects Test	Statistic	d.f.	Prob.
Cross-section F	5.125147	75,222	0.0000
Cross-section Chi-square	305.471181	75	0.0000

Source: Eviews 12 Output

The results in Table 1 indicate that the p-value of the Cross-section F is 0.0000. As the probability value (p-value) is less than 0.05, H0 is rejected, confirming that the Fixed Effect model is appropriate. Consequently, the analysis proceeded with the Hausman Test.

The Hausman Test was performed to select between the Fixed Effect and Random Effect models.

Table 2 Hausman Test Results

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	18.359416	6	0.0054

Source: Eviews 12 Output

Table 2 shows a p-value of 0.0054, leading to the selection of the Fixed Effect model, as the p-value is less than 0.05.

The Breusch-Pagan-Godfrey test (Table 3) was conducted to detect heteroskedasticity.

Table 3 Breusch-Pagan-Godfrey Test Results

F-statistic	Prob. F(6,297)	Obs*R-squared	Prob. Chi-Square(6)
2.198717	0.0631	6.848816	0.0642

The probability value of Obs*R-squared is 0.0642, which is greater than 0.05, indicating no heteroskedasticity issues.

The Durbin-Watson test was used to assess autocorrelation. The results are presented in Table 4.

Table 4 Durbin-Watson Test Results

Durbin-Watson stat
2.030307

As the Durbin-Watson statistic lies between the upper and lower bounds, it can be concluded that no autocorrelation is present.

Table 5 Multicollinearity Test Results

Variable	Centered VIF
EM	1.047061
EO	1.054804
FL	1.037276
FS	1.064473

Multicollinearity was tested by analyzing the variance inflation factor (VIF). The results are shown in Table 5. As all VIF values are below 10, no multicollinearity issues are detected.

Table 6 Moderated Regression Analysis (MRA)

Variable	Coefficient	Std. Error	t-Statistic
C	0.871094	0.146712	5.937422
EM	1.181513	0.469438	2.516868
EO	0.943450	0.283136	3.332148
EM*CG	–0.950858	0.760109	–1.250950
EO*CG	–1.678503	0.491602	–3.414356
FL	0.449198	0.032072	14.00605
FS	2.617312	0.379000	6.905839
R-squared	0.349901		
Adjusted R-squared	0.332271		
F-statistic	19.84710		
Prob(F-statistic)	0.000000		

$$FV = 0.871094 + 1.181\ EM + 0.943\ EO - 0.951\ EM*CG - 1.678\ EO*CG + 0.449\ FL + 2.617\ FS + e$$

Interpretation of the coefficients:

$\beta 0$ = 0.871; This indicates that if Earnings Management, Earnings Opacity, Corporate Governance, Firm Leverage, and Firm Size are all zero, Firm Value will be 0.871.

$\beta 1$ = 1.181; A one-unit increase in Earnings Management leads to an increase of 1.181 in Firm Value, assuming other variables are constant.

$\beta 2$ = 0.943; A one-unit increase in Earnings Opacity results in a 0.943 increase in Firm Value.

$\beta 3$ = –0.951; Corporate Governance weakens the relationship between Earnings Management and Firm Value.

$\beta 4$ = –1.678; Corporate Governance negatively moderates the effect of Earnings Opacity on Firm Value.

$\beta 5$ = 0.449; A one-unit increase in Firm Leverage increases Firm Value by 0.449.

$\beta 6$ = 2.617; A one-unit increase in Firm Size results in a 2.617 increase in Firm Value.

The results indicate that Earnings Management (EM) and Earnings Opacity (EO) have a significant positive effect on Firm Value, while Corporate Governance moderates the relationship negatively, reducing the impact of earnings practices on Firm Value (Table 6).

The findings underscore the substantial and multifaceted impact of Earnings Management (EM) and Earnings Opacity (EO) on Firm Value (FV), reaffirming seminal works by Healy & Wahlen (1999). Earnings Management, while often perceived as a strategic tool to enhance short-term financial performance, reflects managerial discretion aimed at achieving profit targets, smoothing earnings volatility, or responding to market pressures. This manipulation can create the illusion of operational stability, driving investor optimism and boosting stock prices in the short run.

However, despite its initial benefits, the long-term implications of unchecked Earnings Management are concerning. Studies by Beneish et al. (2023) highlight that firms engaging in excessive earnings manipulation risk deteriorating financial health, eroding investor confidence, and facing regulatory scrutiny. Such practices may mask underlying operational inefficiencies, leading to misallocation of resources, inflated asset values, and eventual financial restatements. Over time, this erodes the credibility of financial statements, increasing the firm's cost of capital and exposing it to greater market volatility.

Moreover, the broader economic environment exacerbates the effects of Earnings Management. In volatile markets or periods of economic downturn, firms with aggressive earnings manipulation strategies often face sharper declines in valuation compared to their peers with transparent reporting practices. Research by Hong et al. (2023) suggests that firms in emerging economies are particularly susceptible to these risks due to weaker regulatory oversight and governance frameworks. This underscores the critical need for stringent Corporate Governance (CG) mechanisms to monitor and mitigate the adverse effects of Earnings Management.

Corporate Governance plays a pivotal role in curbing earnings manipulation by promoting transparency, enforcing stricter compliance, and enhancing board oversight (Kassem, 2022). Effective governance structures limit managerial opportunism by aligning executive compensation with long-term performance rather than short-term gains. Additionally, robust audit functions and independent board committees act as critical checks, ensuring that financial reporting reflects the firm's true economic condition.

Thus, while Earnings Management can provide temporary boosts to Firm Value, its sustainability relies heavily on the integrity of governance practices. Firms that proactively enhance their governance frameworks are better positioned to balance earnings optimization with long-term value creation, safeguarding against the detrimental effects of earnings manipulation.

Earnings Opacity exerts a complex influence on Firm Value, reflecting both short-term advantages and long-term vulnerabilities, consistent with the findings of Bhattacharya et al. (2003). In the immediate term, earnings opacity can obscure operational inefficiencies or underperformance, presenting a facade of financial stability that may reassure investors and stabilize stock prices. This temporary concealment can provide firms with the flexibility to navigate challenging market conditions or engage in strategic repositioning without immediate negative repercussions.

However, the prolonged use of earnings opacity poses significant risks, gradually undermining investor trust and impairing the firm's reputation in capital markets. As discrepancies between reported earnings and actual performance accumulate, market participants may perceive the firm as less credible, prompting higher risk premiums and increased capital costs. Research by Dahiya et al. (2017) emphasizes that firms exhibiting persistent earnings opacity are more likely to experience volatility in share prices, reflecting heightened investor sensitivity to transparency concerns. In extreme cases, opacity can trigger regulatory investigations, financial restatements, and legal penalties, further diminishing Firm Value and shareholder returns.

The role of Corporate Governance (CG) is paramount in mitigating these adverse effects. Strong governance structures, characterized by independent boards, rigorous audit committees, and transparent reporting practices, serve as critical safeguards against excessive earnings opacity (Yeung & Lento, 2020). By fostering accountability and enhancing oversight, Corporate Governance reduces managerial discretion in financial reporting, compelling firms to adopt more transparent disclosure practices. This aligns with stakeholder expectations for greater transparency and minimizes the risk of information asymmetry.

Moreover, Corporate Governance acts as a signaling mechanism, conveying the firm's commitment to ethical business practices and sound financial management. Investors are more likely to trust firms with robust governance frameworks, resulting in higher valuations and lower capital costs. Recent studies, such as those by Hong et al. (2023), indicate that firms with effective governance not only mitigate the negative impacts of earnings opacity but also enhance long-term resilience by fostering investor confidence and attracting long-term capital inflows.

In conclusion, while earnings opacity may offer short-term benefits, its sustained application jeopardizes Firm Value unless tempered by strong Corporate Governance. Firms that prioritize governance reforms and enhance transparency are better positioned to sustain investor trust, achieve stable growth, and maximize long-term value creation.

The negative moderating effect of Corporate Governance (CG) on Earnings Management highlights the crucial role governance frameworks play in curbing opportunistic financial practices, aligning with the foundational work of Shleifer & Vishny (1997). Effective governance mechanisms, such as independent boards, transparent reporting procedures, and active audit committees, serve as critical deterrents against managerial tendencies to manipulate earnings for short-term gains. By enforcing stricter oversight and aligning executive compensation with long-term performance, Corporate Governance reduces the incentives for earnings manipulation, fostering more sustainable financial practices. This protective layer not only safeguards shareholder interests but also enhances the overall credibility of the firm's financial statements, reinforcing investor confidence and ensuring market stability.

Conversely, the amplification of the negative effects of Earnings Opacity by Corporate Governance underscores the dual role of governance structures in both preventing and exposing financial irregularities. While governance mechanisms can deter earnings manipulation, they also heighten sensitivity to opacity, as stronger oversight makes inconsistencies and non-transparent reporting practices more apparent. This increased scrutiny may lead to more frequent detection of discrepancies, prompting corrective actions that, in the short term, can negatively impact Firm Value. However, this effect ultimately serves the firm's long-term interests by promoting transparency and reducing the likelihood of financial restatements or regulatory penalties (Guerber & Anand, 2019).

Recent studies, such as those by Lartey et al. (2022), reinforce the notion that firms with rigorous governance frameworks are more resilient to market shocks, as their proactive approach to financial oversight mitigates the adverse consequences of earnings opacity. Additionally, firms with high levels of transparency are better positioned to attract long-term investors who prioritize accountability and ethical financial practices. This dynamic reflects the evolving expectations of modern stakeholders, who increasingly demand greater disclosure and ethical governance from the firms they invest in.

The findings suggest that while Corporate Governance may initially exacerbate the impact of earnings opacity by bringing concealed risks to light, this process ultimately fortifies the firm's integrity and enhances long-term Firm Value. Companies that invest in strengthening their governance frameworks not only mitigate the risks associated with earnings management but also create a foundation for sustainable growth and market leadership (Landi et al., 2022). As regulatory bodies continue to tighten disclosure requirements, firms with proactive governance strategies will be better equipped to navigate complex financial landscapes and maintain competitive advantages.

The positive influence of Firm Leverage and Firm Size on Firm Value provides robust empirical support for the capital structure theory proposed by Modigliani & Miller (1958), reaffirming the critical role financial decisions play in shaping firm performance and market valuation. Firms with higher leverage often experience enhanced market discipline, as debt obligations necessitate stricter financial oversight and efficient resource allocation. Creditors impose rigorous monitoring mechanisms, reducing agency costs and curbing managerial excesses, which in turn enhances operational efficiency and profitability (Guo et al., 2021). This external oversight not only mitigates the risks of underperformance but also signals to investors that the firm is confident in its growth prospects and capacity to generate stable cash flows, ultimately boosting Firm Value.

In addition to leverage, Firm Size emerges as a significant determinant of Firm Value, reflecting the competitive advantages inherent in larger organizations. Larger firms typically benefit from economies of scale, allowing them to spread fixed costs over greater production volumes, thereby improving profit margins and operational efficiency (Chuang et al., 2019). Moreover, larger firms often have greater bargaining power with suppliers and customers, facilitating more favorable contract terms and reducing input costs. These firms are also more likely to attract top managerial talent, invest in innovative technologies, and diversify their product portfolios, all of which contribute to enhanced resilience and long-term growth.

Furthermore, larger firms tend to possess more sophisticated internal control systems and advanced information disclosure practices, fostering greater transparency and reducing information asymmetry. This aligns with investor preferences for stability and predictability, resulting in lower capital costs and higher valuations. Malau et al. (2019) highlight that larger firms, by virtue of their market presence and brand recognition, inspire greater investor confidence, leading to increased stock demand and higher share prices.

However, while higher leverage and larger size are generally associated with positive outcomes, excessive debt levels or overly complex organizational structures can introduce risks. Firms with disproportionately high leverage may face liquidity constraints or default risks during economic downturns, while larger firms may encounter diseconomies of scale, operational inefficiencies, and bureaucratic inertia. As such, the key to maximizing Firm Value lies in striking an optimal balance between leveraging financial resources and maintaining operational agility (Obrenovic et al. 2020).

Recent studies, such as those by Hong et al. (2023), reinforce the notion that firms that strategically manage their capital structures and scale their operations effectively outperform their peers in terms of long-term value creation. This underscores the importance of dynamic financial strategies that align with market conditions, industry cycles, and evolving investor expectations. Ultimately, the interplay between leverage, firm size, and market perception highlights the multifaceted nature of value creation, offering valuable insights for corporate leaders and policymakers seeking to enhance firm competitiveness and shareholder wealth.

Theoretically, this study extends the framework of agency theory by demonstrating the nuanced, dual role of Corporate Governance (CG) in moderating the impacts of both Earnings Management (EM) and Earnings Opacity (EO) on Firm Value (FV). By highlighting how governance mechanisms can simultaneously deter earnings manipulation and expose the detrimental effects of opaque financial practices, the study offers a comprehensive understanding of governance as a dynamic force in mitigating agency conflicts. This dual moderating role underscores that while Corporate Governance curbs excessive managerial discretion in earnings manipulation, it also amplifies the negative consequences of opacity, prompting firms to prioritize transparent reporting practices.

From a managerial perspective, the findings stress the critical need to fortify governance frameworks, aligning internal policies with long-term performance objectives rather than short-term financial gains. Managers are encouraged to adopt robust governance structures that include independent board members, effective audit committees, and stringent internal controls. By fostering greater transparency, firms not only reduce the risk of regulatory penalties but also build sustained investor confidence, positioning themselves as trustworthy market players. This strategic focus on governance not only minimizes the risks associated with earnings manipulation but also enhances overall operational efficiency and market resilience.

Moreover, the study's holistic examination of the interplay between EM, EO, and FV through the lens of CG holds significant implications for developing economies and emerging markets. In such contexts, where regulatory environments and enforcement mechanisms are often less mature, Corporate Governance plays an outsized role in safeguarding shareholder interests and ensuring market stability. This research provides critical insights into how governance practices can be tailored to address specific challenges in emerging markets, contributing to the broader discourse on corporate accountability and investor protection.

For regulators and policymakers, the study serves as an essential reference for crafting governance-related reforms aimed at enhancing transparency and reducing financial misreporting. By illustrating the tangible benefits of strong governance practices on firm valuation and market confidence, the research underscores the urgency of implementing rigorous governance codes, mandatory audit practices, and continuous monitoring frameworks. Investors, too, can leverage these findings to make more informed decisions, prioritizing firms with well-established governance structures and transparent reporting histories.

Academically, this study bridges existing gaps in literature by integrating multiple facets of earnings management, opacity, and governance into a single analytical model, offering a novel contribution to corporate finance and governance theory. The insights derived not only advance theoretical paradigms but also pave the way for future research exploring sector-specific governance impacts, comparative studies across different regulatory environments, and the long-term implications of governance reforms on firm sustainability and performance. Ultimately, this study enriches both the theoretical and practical dimensions of corporate governance, providing valuable pathways for fostering greater accountability and sustainable growth in global markets.

CONCLUSION

The findings of this study demonstrate that Earnings Management and Earnings Opacity significantly influence Firm Value, with Corporate Governance playing a crucial moderating role. While Earnings Management has a direct positive effect on Firm Value, the presence of strong Corporate Governance mitigates this impact, indicating the essential function of governance mechanisms in curbing opportunistic financial reporting. In contrast, Earnings Opacity exerts a significant negative effect on Firm Value when moderated by Corporate Governance, highlighting the importance of transparency and accountability in sustaining firm performance. Additionally, Firm Leverage and Firm Size positively influence Firm Value, reinforcing the significance of financial structure and organizational scale in driving firm performance and investor confidence. This study contributes to the existing body of knowledge by expanding the understanding of the interaction between Earnings Management, Earnings Opacity, and Corporate Governance, offering valuable insights into corporate governance practices and their role in enhancing firm value. The results provide practical implications for policymakers, corporate leaders, and stakeholders by emphasizing the need to strengthen governance frameworks and enforce transparency in financial reporting. However, the study is limited to specific sectors and data from the Indonesia Stock Exchange, which may restrict the generalizability of the findings to other industries or regions. Future research could explore different market conditions, longer observation periods, or comparative analyses across multiple countries to provide a more comprehensive understanding of these relationships. Additionally, incorporating qualitative approaches to assess managerial perspectives on governance and earnings quality could enrich the research framework and offer deeper insights.

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