Earning Management as a Mediator of the Influence of Good Corporate Governance on Company Value in Each Company Life Cycle

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Abstract

This research utilizes the capital structure theory to analyze how debt covenants, corporate governance, and firm value interact, focusing on the mediating role of earnings management across different company life stages. It examines manufacturing firms on the Indonesia Stock Exchange from 2018 to 2022, using a purposive sample of 66 companies. The study employs descriptive and inferential statistical analyses to test the hypothesized relationships, revealing that effective corporate governance significantly enhances firm value, especially during maturity. Earnings management is pivotal in the growth phase, mediating the governance-firm value relationship. This work underscores the importance of adapting governance practices to a company's life cycle stage, offering insights for executives to make financial decisions that improve firm value. It also provides empirical support for agency theory, showing how tailored governance practices can influence firm performance and value.

Keywords: earnings management, good corporate governance, company value, company life cycle

Introduction

The valuation of a company holds utmost importance in the business world, compelling organizations to enhance their performance through the adoption of strategic measures aimed at fulfilling their objectives. The concept of company value is crucial for investors, serving as a critical indicator for market assessments of the company's overall standing. Salvatore (2022) posits that publicly traded companies primarily seek to augment the prosperity of their owners or shareholders by elevating company value. Iswanjuni et al. (2018) suggest that an increase in company value significantly contributes to the welfare of its owners or shareholders. Furthermore, Dovbysh (2019) posits that a company's valuation is inherently reflected in the price potential buyers or investors are prepared to pay.

Central to maximizing company value is the effective collaboration between principals and company agents, a dynamic elucidated by agency theory. This theory anticipates good coordination between principals and

agents to mitigate the effects of agency dilemmas. Jensen & Meckling (1976) have formulated agency theory as forecasting the contractual relationships between principals and corporate agents, with the company acting as the contract's nexus. Eisenhardt (1989) articulated this relationship in three fundamental assumptions: human nature, organizational behavior, and information processing. The contractual relationships often give rise to agency problems, subsequently inducing agency costs.

Echoing the tenets of agency theory, Jensen & Meckling (1976) argue that principals delegate decision-making responsibilities to agents, granting them autonomy based on various considerations, including self-interest. In practice, agents frequently encounter scenarios necessitating company direction and oversight to enhance performance. This requirement underscores the necessity for companies to implement good corporate governance (GCG) as theorized by Jensen & Meckling (1976). The adoption of GCG mechanisms is anticipated to alleviate agency conflicts between principals and agents, thereby optimizing shareholder welfare and augmenting company value.

Empirical research on the impact of good corporate governance on company value has yielded diverse outcomes. Livnat et al. (2021) and Ni et al. (2020) observed that effective corporate governance bolsters company value by enhancing investor interest and confidence. Bakar et al. (2020) demonstrated the role of the independent board, serving as a proxy for good corporate governance, in positively influencing company value through directing and controlling actions. Conversely, Huang et al. (2020) and Rashid (2017) found that corporate governance, as proxied by board independence, does not significantly affect company value, presenting a nuanced view of the relationship between corporate governance practices and firm valuation.

Based on theoretical controversy and empirical studies of the findings of good corporate governance on company value, it is a gap in this research to place earnings management as a mediating variable. An empirical study conducted by Asghar et al. (2020) revealed that GCG through board size has a positive relationship to earnings management. The findings support the view that larger boards appear to be less effective in their oversight duties compared with smaller boards (Saputra, 2018). A possible explanation for the insignificant relationship between other corporate governance mechanisms (independence of the board and audit committee) and earnings management is that boards are seen as ineffective in carrying out their monitoring duties due to management's dominance over board matters (Lu et al., 2019). The obvious reason for this phenomenon is attributed to the board's lack of knowledge in corporate affairs (Ekayani et al., 2020).

Empirical investigations conducted by Putri & Saputra (2021) have demonstrated that larger board sizes exert a positive impact on earnings management practices. Contrarily, a higher ratio of independent non-executive directors on the board does not necessarily enhance the effectiveness of monitoring mechanisms to curb earnings management behaviors. This observation aligns with findings from Aguiar et al. (2021), Ge & Xu (2021), and Qureshi & Siddiqui (2021), which also scrutinize the complex dynamics between board composition and earnings management. In an extension of

examining the nexus between good corporate governance and firm value, this study integrates earnings management as a mediating variable and incorporates the company life cycle as a controlling factor for earnings management. The concept of the company life cycle, as articulated by Saputra et al. (2019), delineates the distinct phases of organizational evolution, each characterized by unique attributes in terms of situational context, strategy, structure, and decision-making style, specifically: birth, growth, maturity, revival, and decline. This research, however, will omit the decline phase due to data constraints and the sensitivity of the subject matter (Narindra et al., 2023).

This study seek to explore the stage within the company life cycle where the enactment of sound corporate governance practices, facilitated through earnings management, optimally enhances firm value. It aims to dissect the effect of good corporate governance on firm value, with earnings management serving as a mediating factor across different life cycle stages of companies. The analysis will focus on manufacturing firms listed on the Indonesia Stock Exchange (IDX) from 2018 to 2022.

Firm value is conceptualized as investors' perception, often correlated with stock prices, where higher stock prices indicate elevated firm value. According to the firm theory, the primary objective of a company is to maximize its value or wealth (Salvatore, 2022). In this research, firm value is quantified using Tobin's Q ratio, reflecting the market's estimation of future investment returns as perceived by external parties and investors. The enhancement of firm value necessitates the implementation of a Good Corporate Governance (GCG) mechanism grounded in five cardinal principles: transparency, accountability, responsibility, independence, and fairness. Pedersen et al. (2021) suggest that investor interest and confidence burgeon alongside the effective implementation of corporate governance, thereby positively influencing firm value. The presence of an independent board, serving as a proxy for sound corporate governance, has been empirically validated to augment firm value (Bakar et al., 2020). Additional empirical studies corroborate that GCG, as an embodiment of effective governance, positively impacts firm value by bolstering investor interest and confidence. Furthermore, Bakar et al. (2020) indicate that strategic direction and oversight by an independent board significantly contribute to enhancing firm value. Drawing from the review of prior research, the hypothesis is posited as follows:

H_1: Good corporate governance influences company value

Earnings management strategies encompass both accrual earnings management (AEM) and real earnings management (REM). According to Putri & Saputra (2021), the choice between REM and AEM by managers hinges on a variety of factors including the firm's future prospects, managerial incentives, and the associated costs of REM. Roychowdhury (2006) provides evidence suggesting that managers engage in REM activities to circumvent reporting losses in annual financial statements, employing tactics such as offering discounts to boost sales.

Empirical research by Ni et al. (2020) indicates a positive correlation between good corporate governance (GCG), as manifested through board size, and earnings management. It was observed that larger boards tend to be less effective in exercising their supervisory roles compared to smaller ones. This observation is echoed by Asghar et

al. (2020), who noted that companies with relatively large board sizes are more inclined towards earnings management practices. Moreover, increasing the proportion of independent non-executive directors on the board does not necessarily lead to more effective oversight of earnings management activities. Similar findings are reported by Ekayani et al. (2020), Putri & Saputra (2021), Qureshi & Siddiqui (2021), and Saputra (2018), further reinforcing the notion that larger board sizes may inadvertently facilitate earnings management.

This study also examines earnings management as a mediating variable in the relationship between good corporate governance and company value, across different stages of the company life cycle, serving as a control variable. This framework suggests that GCG could exert a positive influence on the earnings management practices adopted by firms. Therefore, the hypothesis proposed for this investigation is as follows:

H_2: Good corporate governance influences earnings management

Earnings management undertaken by company agents serves various objectives, with a primary goal in this research being to enhance the appeal of the company to investors and creditors, thereby expected to elevate the company's value. Empirical studies by Asghar et al. (2020) have demonstrated that earnings management, particularly in the form of income smoothing, positively impacts company value. Firms employing income smoothing techniques exhibit a favorable correlation with their valuation, suggesting that earnings management strategies positively influence financial performance.

Andini & Sukartha (2020) align with this perspective, positing that earnings management via income smoothing should be viewed as a strategic maneuver by managers, reflecting an optimistic outlook on the company’s future operational achievements. Kirana et al. (2020) further argue that such practices contribute to reduced cash flow volatility and enhanced predictability of company earnings. Similarly, Arnas et al. (2021) concur that earnings management plays a significant role in augmenting company value. They propose that earnings management acts as a signaling mechanism, allowing management to demonstrate the company's quality or performance to the market. The manipulation of financial statements to project higher profitability may be perceived as an indicator of strong company performance and promising future prospects.

Therefore, the hypothesis posited for examination in this study is as follows:

H_3: Earnings management influences company value.

The concept of the company life cycle is instrumental in delineating the various developmental stages of an organization, each characterized by distinct features. Ghofir & Yusuf (2020) categorize these stages into five distinct phases—birth, growth, maturity, revival, and decline—based on an integrated analysis of four contingent variables: organizational situation, strategy, structure, and decision-making style. Notably, the decline phase was excluded from their research due to data constraints and the sensitivity of the subject matter.

Agency theory posits the inevitability of conflicts between different parties within a company, such as principals and agents, suggesting that individuals tend to act in self-

interest rather than altruistically (Mardini & Lahyani, 2022). This theoretical perspective further elucidates that effective corporate governance can enhance company value by facilitating management oversight, improving information provision and dissemination, and boosting investor recognition.

Contrasting findings emerge from the empirical literature on the impact of corporate governance on company value. Huang et al. (2020) observed that corporate governance does not significantly affect company value in the Australian context, a sentiment echoed by Prawida & Sutrisno (2021), who found that board independence, as a proxy for corporate governance, does not positively influence company value.

Conversely, Bakar et al. (2020) argue that an independent board can enhance managerial oversight, aligning with agency theory by suggesting that good corporate governance can mitigate agency risks through effective control systems for monitoring managerial actions, thereby streamlining the relationship between principals and agents in the enforcement of Good Corporate Governance (GCG) mechanisms. Saeed & Al-Abedi (2020) further posit that sound corporate governance practices can draw investor interest and trust, leading to increased share and company values, as well as improving the company's public image. Similarly, Asghar et al. (2020) report that corporate governance significantly bolsters company value and performance.

Given these divergent perspectives, this research proposes to examine earnings management as a mediating variable within the interplay of good corporate governance (GCG) and company value, moderated by the company's life cycle stage. Earnings management is posited to act as a mediating mechanism in this relationship. Therefore, the hypothesis for this study is formulated as follows:

H_4: Earnings management is able to mediate the influence of good corporate governance on company value

Research Method

This research analyzes the influence of good corporate governance variables on company value directly and indirectly through earnings management. To provide a broader understanding, the research includes the company life cycle (OLC) in earnings management as a mediating variable. This mediating variable will be controlled by the company's life cycle by identifying the four stages of the company's life cycle (birth, growth, maturity, and revival). This research was conducted over a certain sequence of time periods (time series) using many samples (cross sectional), so it is research with panel data (pooled data). The panel data used is secondary data sourced from official publications on the company website and the IDX website. Research data was obtained from annual reports which were then analyzed using the panel regression analysis method using the STATA 16 tool. This analysis aims to test the hypothesis that has been formulated so that it can answer the research problem.

This research was conducted in Indonesia by observing the population of manufacturing sector companies listed on the Indonesia Stock Exchange by looking at published financial reports. This research period starts from 2018 to 2022. The sampling technique is non-probability sampling, namely using a purposive sampling technique. The

criteria used in determining the sample in this research were manufacturing sector companies listed on the Indonesia Stock Exchange in the period 2018 to 2022 with the criteria (1) listed consecutively during the observation period 2018 - 2022, (2) companies that entered into a debt covenant with a lender registered with the Indonesia Banking Award, (3) the company did not carry out a rights issue during the observation period, (4) the company did not experience a loss.

Table 1. Determining the Research Sample

No	Criteria	Number of Samples
1	Manufacturing Sector Companies listed on the Indonesia Stock Exchange in 2018– 2022	222
2	Manufacturing Sector Companies that were not listed consecutively on the Indonesia Stock Exchange in 2018 – 2022	(77)
3	debt covenants with lenders that are not registered with the Indonesia Banking Award	(17)
4	Carrying out a rights issue during the observation period	(20)
5	Companies that experience losses	(42)
6	Manufacturing companies in the sample	66

Source: Processed Data, 2023

The data in the table above shows that the number of manufacturing companies in the 2018 - 2022 period that are worth observing in this research is 66 companies. The observation period was 5 years, so the number of samples observed in this study was 330 units. The data collection method in this research uses the non-participant observation method. This method is implemented by observing the annual reports of manufacturing sector companies listed on the Indonesia Stock Exchange (BEI) for the period 2018 to 2022. This research uses Stata to describe data through descriptive analysis and test hypotheses through inferential analysis , and panel data regression analysis is used to test research hypotheses .

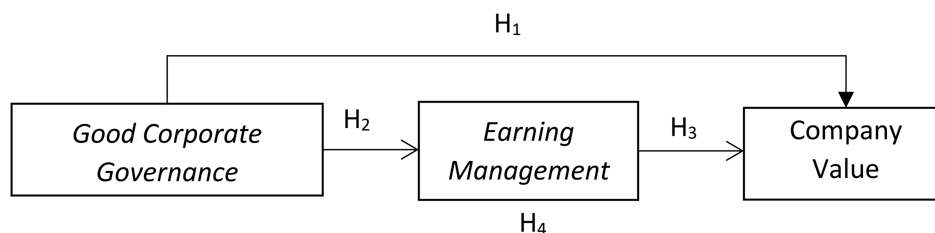

Figure 1. Research Conceptual Framework

Source: Processed Data, 2023

The overall conceptual framework model describes the influence between variables. This research uses an exogenous variable, namely good corporate governance, an endogenous variable, namely company value, and a mediating variable, namely earnings management. The operational variable for firm value is measured using Tobin's Q ratio, using the sum of the market value of common equity, book value of preferred shares, book value of long-term debt and net current liabilities (Chen & Hung, 2021). Good corporate governance reflects instruments in corporate governance which are proxied by

the role of the independent board of commissioners comparing independent commissioners with the board of commissioners (Hashed & Almaqtari, 2021). Earnings management is measured using discretionary accruals (Mardjono & Chen, 2020). The analysis technique for this research is descriptive statistical analysis and inferential analysis (Irawan et al., 2020). The analytical method used in descriptive and inferential testing is panel data regression analysis. The panel data in this research is secondary data processed with Stata.

Results and Discussion

Descriptive statistics show that the average company value is 0.584, meaning that the average sample company's shares are undervalued . The average level of debt equity ratio for sample companies is still low, namely 0.948. The average good corporate governance score of 0.392 is still quite low compared to the proportion of independent commissioners in the company. The average earnings management value is 0.0056 and the average company OLC value is 0.282. The following are the results of the descriptive analysis that has been carried out in the following table:

Table 2. Results of Descriptive Statistical Analysis

Variable	N	Minimum	Maximum	Average	Standard deviation
Company Value	330	0.0001	5.725	0.584	0.391
Good Corporate Governance	330	0.0001	0.8	0.392	0.115
Earning Management	330	-1.435	1.204	0.005	0.147

Source: Processed Data, 2023

When Tobin's Q < 1, a company can be classified as cheap (undervalued) because its book value is higher than its market value. The standard deviation shows the magnitude of the deviation from observations of company value data to the expected value or average value. The standard deviation value is 0.3916 smaller than the average, meaning that the data distribution is homogeneous. The value of good corporate governance (GCG) which is proxied by the proportion of Independent Commissioners in the company the lowest (minimum) manufacturing value is 0.0001 and the largest (maximum) value is 0.8. The minimum value shows that there are still companies that do not have independent commissioners in the company. The average company GCG value is 0.3928. The standard deviation shows the magnitude of the deviation from GCG data observations to the expected value or average value. The standard deviation value is 0.1159 smaller than the average, meaning that the data distribution is homogeneous.

Value of earnings management (EM) within the company The lowest (minimum) manufacturing value is -1.4359 and the largest (maximum) value is 1.2042. The company's average EM value is 0.0056, which indicates that the company made an adjustment of 0.0056 from its actual expenditure based on the chosen accounting policy. This amount reflects subjective estimates or accounting policies that may affect the company's financial statements.

Table 3. Results of Panel Regression Model Selection for the Entire Company Life Cycle

Test	Model 1			Model 2		
	Statistics	Prob.	Conclusion	Statistics	Prob .	Conclusion
Chow	1.97	0.0001	Fixed Effect Model	1.77	0.0009	Fixed Effect Model
Hausman	2.38	0.4980	Random Effect Model	1.73	0.6314	Random Effect Model
L.M	15.93	0.0000	Random Effect Model	10.95	0.0005	Random Effect Model

Source: Processed Data, 2023

Based on the three tests in Table 3, it can be concluded that the random effect model (REM) is the best for the regression model obtained in this research in equation 1 and equation 2 because the resulting probability value is more than 0.05. Next, hypothesis testing is carried out. Hypothesis testing aims to determine the influence of the independent variable on the dependent variable, as well as the mediating role of the mediating variable, namely earnings management. Testing the two-tailed test on a one-way hypothesis with a significance level of 0.05 causes the output significance value to be divided by two to determine the test criteria.

Table 4. Regression Analysis Results of the Effect of Good Corporate Governance and Earning Management on Company Value Throughout the Company's Life Cycle

Variable	Beta	z	P>|z|	Information
Good Corporate Governance	-0.062	-1.15	0.251	Not significant
Earnings management	0.173	3.27	0.001*	Significant
R-squared	0.1067			

Source: Processed Data, 2023

The test results show that the good corporate governance variable has a coefficient of -0.062 with a p-value of 0.251 which is greater than 0.05, so it can be stated that good corporate governance has an insignificant negative effect on company value. The table also provides test results which show that the earnings management variable has a coefficient of 0.173 with a p-value of 0.001, which is smaller than 0.05, so it can be stated that earnings management has a significant positive effect on company value.

Table 5. Results of Regression Analysis on the Effect of Good Corporate Governance and OLC on Earning Management throughout the Company's Life Cycle

Variable	Beta	z	P>|z|	Information
Good Corporate Governance	-0.121	-2.17	0.030	Significant
OLC	-0.163	-2.50	0.012	Significant
R-squared	= 0.0689			

Source: Processed Data, 2023

Good corporate governance variable has a coefficient of -0.121 with a p value of 0.030, which is smaller than 0.05, so it can be stated that good corporate governance has

a significant negative effect on earnings management. The test results also show that the OLC control variable has a coefficient of -0.163 with a p-value of 0.012, which is smaller than 0.05, so the OLC variable has a negative and significant effect on the Earning Management variable.

Table 6. The Indirect Influence of Good Corporate Governance on Company Value through Earning Management throughout the Company's Life Cycle

Variable	Coefficient	Sobel (p-value)	Information
X – Z – Y	-0.021	-1.810 (0.070)	Not significant

Notes: X: good corporate governance; Z: earnings management; Y: company value

Source: Processed Data, 2023

The indirect influence test in this research is to test the influence of good corporate governance on company value through earnings management. Based on the test results, it is known that there is an indirect influence between the good corporate governance variables on the firm value variable through the earnings management variable is not significant, with a negative indirect effect coefficient and a Sobel test significance of 0.070 greater than 0.05. The earnings management variable does not mediate the effect of good corporate governance on company value.

Table 7. Summary of Hypothesis Testing Results

Hypothesis	Prediction	Beta Value	Results	Mark Sig	Description	Conclusion
H1: GCG > NP	+	-0.062	-	0.251	Not significant, different direction	Not accepted
H2: GCG > EM	+	-0.121	-	0.030	Significant, different direction	Not accepted
H3: EM > NP	+	0.173	+	0.001	Significant, same direction	Accepted
H4a: GCG > EM > NP(birth)	+	-0.003	-	0.850	EM does not mediate GCG > NP	Not accepted
H4b: GCG > EM > NP(growth)	+	-0.081	-	0.004	EM mediates GCG > NP	Accepted
H4c: GCG > EM > NP (maturity)	+	-0.068	-	0.216	EM does not mediate GCG > NP	Not accepted
H4d: GCG > EM > NP (revival)	+	-0.053	-	0.490	EM does not mediate GCG > NP	Not accepted

Source: Processed Data, 2023

The examination of Good Corporate Governance (GCG) and its impact on company value reveals that GCG has a negative effect on company value within the manufacturing sector companies listed on the Indonesia Stock Exchange (IDX) for the period 2018-2022. According to Andini & Sukartha (2020), this outcome may arise from

the partial implementation of GCG principles by these companies, suggesting an incomplete adoption of GCG standards.

The influence of GCG on the financing decisions of creditors or potential creditors is pivotal across every stage of a company's life cycle. Chava et al. (2019) observed that both creditors and shareholders prefer to limit actions potentially motivated by managerial agency conflicts. Agency theory suggests that a company represents a series of contracts aimed at minimizing agency costs, which stem from asymmetric information and conflicts of interest among company stakeholders, notably affecting the risk borne by debtholders (Ghofir & Yusuf, 2020; Prawida & Sutrisno, 2021).

GCG, reflecting in terms of direction and supervision, is anticipated to enhance the company's performance. The agency theory framework explicates the contractual relationships between agents and principals, with the company serving as the contract's nexus (Kiesnere & Baumgartner, 2019; Ni et al., 2020). Enhanced governance by the company agent is expected to positively affect the company's performance, including in the context of debt contract agreements, potentially leading to financial benefits such as increased profitability and company value (Saputra et al., 2023). However, this research supports the findings of Huang et al. (2020) and Rashid (2017), where corporate governance, as proxied by board independence, does not demonstrate a positive influence. Conversely, Asghar et al. (2020) and Bakar et al. (2020) suggest that a robust GCG system can significantly improve the company's image.

In this study, GCG is proxied by the role of the independent board of commissioners within the company. Strict supervision makes it challenging for management to manipulate profits undetected. Moreover, GCG fosters a high level of transparency in financial reporting, indicating that enhanced GCG practices will reduce earnings management practices, thus aligning with agency theory which advocates for the implementation of GCG to mitigate conflicts of interest between shareholders and management.

The findings indicate that earnings management positively affects company value in the manufacturing sector companies listed on the IDX for the 2018-2022 period. Management's use of earnings management as a signal of the company's quality or performance to the market suggests that financial statement manipulation to project higher profits can signal robust company performance and future prospects. This is consistent with research by Chen & Hung (2021), which finds that income smoothing, a form of earnings management, increases company value. Such earnings management actions provide stable profit information, signaling good financial health.

However, earnings management fails to mediate the impact of GCG on company value across the birth, maturity, and revival stages of the company life cycle, indicating that during these stages, earnings management does not enhance the effect of GCG on company value. Conversely, during the growth stage, earnings management mediates the relationship between GCG and company value, suggesting that in growth-stage companies, earnings management practices can influence the nexus between GCG and company value by affecting the transparency of information presented to stakeholders. This finding is in accord with agency theory, which posits that earnings management

introduces risk, and that effective corporate governance can mitigate this risk through optimal control systems overseeing managerial activities, thereby facilitating an efficient principal-agent relationship under GCG mechanisms.

Conclusion

The study's findings indicate that good corporate governance enhances company value predominantly within the maturity stage of companies. Additionally, earnings management mediates the effect of good corporate governance on company value specifically in the growth phase of the company life cycle. Contrasting outcomes revealed that good corporate governance negatively impacts company value and exerts an adverse effect on earnings management. The positive influence of earnings management on company value underscores efforts by companies to project favorable signals to stakeholders. However, it is advised that companies exercise caution regarding earnings management practices, as excessive or regulatory non-compliant earnings management can erode trust among lenders and shareholders, leading to potential legal and reputational repercussions detrimental to the company. Earnings management's capacity to mediate the relationship between good corporate governance and company value is exclusive to the growth life cycle phase, failing to act as a mediator during the birth, maturity, and revival stages. This suggests that in the growth stage, earnings management enables good corporate governance to effectively mitigate agency risk through optimal control systems and managerial oversight, thus facilitating an efficient principal-agent dynamic in the implementation of Good Corporate Governance (GCG) mechanisms to enhance company value.

The research implications are directed towards understanding the impact of good corporate governance on company value, thereby informing investors and creditors to consider factors such as good corporate governance when making investment decisions in capital and financial markets. The findings also offer practical insights for corporate executives regarding financial strategies, including funding decisions across various stages of the company life cycle, in relation to leveraging levels and the execution of good corporate governance practices.

The study's scope regarding the company life cycle as a control variable was limited to the birth, growth, maturity, and revival stages, explicitly excluding the decline stage due to data constraints and the sensitivity of this phase.

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