The Impact of Earnings Management on Firm Value: A Conceptual Framework

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Abstract

Earnings management is considered a tool to help managers present business results flexibly, but it also has the potential to distort accounting information, thereby affecting investors' decisions and business valuation in the market. However, many research results show that the relationship between earnings management and firm value is still inconsistent. This study is based on agency theory and signaling theory to propose a conceptual framework that highlights the impact of earnings management on firm value, integrating the moderating role of firm size.

Keywords: earnings management, firm value, firm size, conceptual framework.

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1. Introduction

In the context of the increasingly developed financial market and information transparency becoming an inevitable requirement, the issue of earnings management is increasingly attracting the attention of researchers and policymakers. Earnings management, although considered a tool to help managers be flexible in presenting business results, also has the potential to distort accounting information, thereby affecting investors' decisions and business valuation in the market. However, the existing empirical evidence on the relationship between earnings management and firm value is still limited and inconsistent. Some studies have shown that earnings management leads to undervaluation of firms, and this effect becomes more pronounced in the long run (Fernandes & Ferreira, 2011). In this case, the managers' implementation of earnings management not only undermines investor confidence but also hinders the sustainable growth prospects of the firm. However, some studies have shown a positive impact of earnings management on firm value under certain conditions (Hernawati et al., 2021; Subanidja et al., 2016). The differences in research results show that the impact of earnings management is not uniform, but depends on the purpose of implementation and the specific context of each firm.

Furthermore, most of the previous studies mainly examined the linear relationship between earnings management and firm value, while the possibility of nonlinear relationships or moderating effects has not been fully explored. Therefore, later studies have added moderating variables that can change the nature and intensity of the earnings management-firm value relationship, such as audit quality (Tarmidi & Murwaningsari, 2019; Karianga & Kasingku, 2022), good corporate governance (Asshiddiq, 2016; Subanidja et al., 2016; Latifah & Novitasari, 2021; Islami & Firmansyah, 2024), and independent commissioner (Limarwati et al., 2023), but the number of studies is still quite modest and has not obtained meaningful results. This raises the need for additional studies, considering other factors that may impact the relationship between earnings management and firm value. Therefore, this study was conducted to expand the conceptual framework on the impact of earnings management on firm value by examining the moderating role of firm size - a factor reflecting resource capacity and internal monitoring ability, to provide a more comprehensive perspective on the impact mechanism between earnings management and firm value.

2. Literature Review

2.1. Agency Theory

Agency theory (Jensen & Meckling, 1976) explains the relationship between owners (principals) and managers (agents), in which conflicts of interest arise when the goals of the two parties are not aligned. Due to the separation of ownership and control, managers can engage in behaviors that maximize their own interests, including earnings management. In this context, earnings management is viewed as a consequence of information asymmetry and agency costs, which can affect the valuation of firms in the market.

The agency theory from the efficiency perspective suggests that, in certain contexts, managers can use earnings management as an effective tool to communicate internal information to the market, thereby reducing information asymmetry and leading to an increase in firm value (Abbas, 2018). However, when viewed from the opportunistic perspective, earnings management behavior mainly arises from managers' self-interest when there is a conflict with shareholders' interests. Empirical evidence from developed markets shows that this behavior not only reflects inefficiencies in internal monitoring mechanisms and deficiencies in corporate governance structures, but also directly leads to adverse consequences such as loss of market value, increased cost of capital, and reduced investment efficiency (Biddle et al., 2009; Francis et al., 2005).

2.2. Signaling theory

Signaling theory originated from Spence's (1978) study of the labor market to deal with the problem of information asymmetry between business owners and employees. Later, this theory was extended to the field of finance and accounting, especially in explaining the behavior of voluntary disclosure and information disclosure in financial statements, where there is an information asymmetry between shareholders and managers (Ross, 1977). According to signaling theory, in conditions of asymmetric information, managers can use accounting adjustments as a tool to convey positive signals about the management capacity, performance, or future prospects of the business (Ross, 1977). Adjusting to a reasonable extent within the scope of accounting standards can help managers communicate internal information that is difficult to observe to the outside, which is interpreted by the market as a good signal, thereby reducing information costs and enhancing market valuation (Kasznik, 1999). To demonstrate stable operating performance and growth prospects, managers can manage earnings (Sun & Rath, 2008). This action, in some cases, can contribute to maintaining earnings stability and positively impact stock prices (Yimenu & Surur, 2019). In this context, earnings management behavior can be viewed as a strategic signaling behavior.

Recent empirical studies have also shown that, in specific contexts – such as when a firm is in the growth stage, preparing to issue shares, or under pressure from institutional investors – earnings management behavior can be interpreted by the market as a positive signal, thereby increasing the value of the firm in the short term (Chen et al., 2015). Therefore, from the perspective of signaling theory, the impact of earnings management on firm value is not entirely negative, but also depends on the motive, level, and information context in each specific case.

2.3. Earnings management

The term earnings management has been of interest to academics for decades, but there has been no consensus on a standard academic concept. The diversity of research approaches and practical application goals has led to the existence of many different definitions. In the field of financial accounting, earnings management is understood as the proactive intervention of managers in the financial reporting process to meet personal or organizational goals. Schipper (1989) defines this phenomenon as a form of "disclosure management", that is, the systematic impact on the external financial reporting process. In terms of implementation, earnings management is implemented through two main mechanisms: "accounting policy choices and cash flow management from operations" (Phillips et al., 2003). This behavior is likely to be driven by various factors, including internal management needs, the need to meet market forecasts, or the goal of presenting a stable earnings model (Mulford & Comiskey, 2005), which can be neutral, beneficial, or detrimental, depending on the extent to which it truly reflects the sustainable performance of the business (Ronen & Yaari, 2008).

Earnings management is divided into two forms: accrual-based earnings management and real earnings management (Healy & Wahlen, 1999). Accrual-based earnings management is carried out based on the flexible application of accounting policies, while real earnings management is carried out by intervening in the actual business activities of the company (Darmawan et al., 2019). Increasing earnings management can help companies increase capital mobilization opportunities, increase stock value, or maximize the welfare of the managers themselves, while decreasing earnings management helps companies reduce tax burden, adjust market expectations, or build a "profit buffer" for the following periods.

Models measuring accrual-based earnings management are key quantitative tools in accounting research, built on the premise that total accruals can be decomposed into two components: non-discretionary accruals, which reflect the actual economic transactions of the firm; and discretionary accruals, which represent earnings management behavior. The most fundamental and influential model is the Jones (1991) model, which uses changes in sales and fixed assets to estimate the non-discretionary accruals. The Modified Jones model was later developed by Dechow et al. (1995) to address the limitation in detecting revenue manipulation by assuming that all changes in receivables are discretionary. Subsequent variants, such as the model by Kothari et al. (2005), added a return on assets (ROA) variable to control for biases due to firm performance, and the model by Raman & Shahrur (2008) added a BM variable to provide additional corrections to control for growth options. Despite the debates about the specificity and noise of the estimates, these models remain the standard method for quantifying accrual-based earnings management in empirical research.

Compared to the models measuring accrual-based earnings management, very few models have been developed to measure real earnings management, notably the models of Roychowdhury (2006) and Gunny (2010), which both emphasize managerial decisions to manipulate discretionary costs and production to improve earnings. However, while Roychowdhury (2006) focuses on some managerial decisions related to sales manipulation, Gunny (2010) emphasizes decisions that allow manipulation of asset sales and investments. Although the models of Gunny (2010) incorporate more variables to explain the dependent variables than the models of Roychowdhury (2006), both models still suffer from endogeneity due to the problems of simultaneity, omitted variables, and measurement errors (Diri, 2017).

2.4. Firm value

Firm value reflects the ability to generate future economic profits, formed from investors' expectations of the level of profits that the company can bring (Chaney & Lewis, 1995). In other words, firm value is the investor's perception of the success of a company, expressed through the stock price on the market (Jihadi et al., 2021; Almari et al., 2021; Margono & Gantino, 2021). Firm value plays a key role for both the company and its stakeholders, serving as the basis for many activities such as issuing shares, equitization, joint ventures, capital contributions, business mergers and acquisitions, etc. For listed companies, firm value is closely related to the company's stock value. Stock price is considered a measure of the real asset value of the company. Maintaining a high stock price means maintaining an attractive firm value, thereby attracting investors. Conversely, a decline in firm value can lead to a decline in investor confidence, thereby threatening the long-term and stable growth of the company.

In empirical studies, the M/B ratio and Tobin's Q are often used as proxies for measuring firm value. M/B represents the correlation between market value and book value of equity. The advantage of this ratio is that it is easy to calculate due to the data available from financial statements, but the book value of equity can be distorted due to the accounting policies of the company. Many empirical analyses have used the M/B ratio to represent the measurement of firm value variables, such as Susanto (2017), Margono & Gantino (2021), Ahmad et al. (2022), and Yahya et al. (2024). Tobin's Q represents the relationship between the market value and the replacement cost of a firm's assets, developed by James Tobin. This index reflects the investment opportunities (Lang et al., 1989) and the growth potential of the firm (Tobin, 1969; Tobin & Brainard, 1990). A Tobin's Q greater than 1 indicates the attractiveness of investing in assets, while a value less than 1 reflects the unattractiveness (Handayani & Ibrani, 2020; Ibrani et al., 2019). However, measuring Tobin's Q using the original formula has some obstacles, such as the difficulty in measuring the replacement value of assets and the lack of market value of debt. Therefore, Chung & Pruitt (1994) proposed a simpler variant to measure Tobin's Q, which is calculated as the ratio of the total market value of equity plus the book value of debt to the book value of total assets. Compared to the original formula, this formula is favored in quantitative research due to its high feasibility when calculating with available secondary data, thereby increasing the efficiency of measuring firm value (Ayuba et al., 2019; Dang et al., 2020; Priyanto & Aryati, 2023). This formula allows easy measurement through data from the stock market and financial statements, and effectively connects the real and virtual values of the company.

2.5. Impact of earnings management on firm value

The results of empirical analysis on the relationship between earnings management and firm value so far still have many conflicting views. From the perspective of agency theory, according to the efficiency perspective, earnings management is considered a tool that managers can use to increase of firm's value. According to Abbas (2018), earnings management can have positive impacts on the development of firm value if implemented properly. Some empirical evidence has reinforced this argument. Specifically, Hernawati et al. (2021) and Subanidja et al. (2016) in Indonesia, based on the model of Dechow et al. (1995) combined with Tobin's Q index, have shown a positive relationship between earnings management and firm value. Meanwhile, Abbas & Ayub (2019) in Pakistan, applying the Kasznik (1999) model to measure earnings management, showed that earnings management has a positive impact on firm value when represented by cash flow and non-discretionary net income. In Vietnam, Dang et al. (2020) confirmed the positive impact of earnings management on firm value when the Jones (1991) model and Tobin's Q were chosen to measure these two variables. These results are consistent in affirming that higher levels of earnings management tend to be associated with increased firm value.

In contrast, many other studies based on the opportunistic perspective of agency theory argue that earnings management arises mainly from managers' self-interest motives, which harms firm value. Thenmozhi et al. (2019) in China, using the model of Dechow et al. (1995) and Kothari et al. (2005), found that earnings management negatively affects firm value as measured by Tobin's Q. Similar results were found in studies by Chen et al. (2023) in the US and Li et al. (2017) in China, where higher levels of discretionary accruals lead to lower earnings quality, which in turn reduces firm value. Additionally, some studies did not find a statistically significant relationship between these two variables (Darmawan et al., 2019; Challen & Siregar, 2012; Ishak, 2024), suggesting that the impact of earnings management may depend on country characteristics, industry characteristics, or the measurement method used.

The above inconsistency has prompted a new research trend, focusing on identifying moderating variables that can alter the nature and intensity of the earnings management-firm value relationship. Several studies have demonstrated that good corporate governance, such as managerial ownership, institutional ownership, audit committees, or the independent board of commissioners, significantly limits the negative impact of earnings management on firm value (Latifah & Novitasari, 2021; Subanidja et al., 2016). Similarly, high audit quality is considered an effective monitoring mechanism, where reputable auditors within their mandate can prevent earnings management activities (Tarmidi & Murwaningsari, 2019). However, these results are not entirely consistent; some other studies (Asshiddiq, 2016; Limarwati et al., 2023; Karianga & Kasingku, 2022; Islami & Firmansyah, 2024) found that factors such as board size, independent directors, managerial ownership, institutional ownership, or audit quality do not have a significant moderating role. Although mainly focused on corporate governance factors, these pioneering studies have established an important premise: the impact of earnings management on firm value is not a linear relationship, but is strongly influenced by the intrinsic characteristics of the company. From that basis, the inclusion of firm size into the model as a moderating variable is a logical and necessary development. Firm size is not only a basic characteristic but also a representative of a series of advantages in resources, governance structure, and risk tolerance, promising to provide a new, more comprehensive lens to explain the contradictions in previous empirical findings.

3. A conceptual framework for assessing the impact of earnings management on firm value

3.1. Earnings management and firm value

According to agency theory, when managers choose to implement earnings management, the goal of that action is for their own benefit instead of the benefit of shareholders. However, the profit of the company only increases on the books but not in reality, so the value of the company will be affected over time. Therefore, earnings management can have an adverse impact on firm value. Thenmozhi et al. (2019), Darmawan et al. (2019), Almari et al. (2021), and Chen et al. (2023) have consistently found that the higher the earnings management, the lower the value of the company. Therefore, the research hypothesis is proposed as follows:

H1: Earnings management has a negative impact (-) on firm value.

3.2. Firm size and firm value

a. Firm size as a control variable

Competitiveness and market presence of an organization in the industry are reflected in firm size. The larger the firm, the more public it will be known, which means it is easier to obtain information that increases shareholder value (Rusmin et al., 2014). This situation will increase the firm's stock price, thereby increasing firm value (Brealey et al., 2014). Ayuba et al. (2019), Lumapow & Tumiwa (2017), Natsir & Yusbardini (2019), and Rizqia et al. (2013) also confirmed that firm size is positively correlated with firm value. Therefore, the research hypothesis is proposed as follows:

H2: Firm size has a positive (+) impact on firm value.

b. Firm size as a moderating variable

In addition to its role as a control variable, firm size is further examined for its potential moderating effect, given its theoretical relevance in shaping firms' transparency, governance capacity, and market perception.

Firm size has been examined as a moderating variable in studies related to firm value and has shown a significant impact (Yuliyanti et al., 2022; Sugiyanto et al., 2021; Almomani et al., 2022). However, in studies on the relationship between earnings management and firm value, this variable is mainly used as an independent variable or a control variable, and there is no clear evidence of its moderating role.

In the context of agency theory and information asymmetry, large-scale companies often have a higher level of information disclosure, are more subject to monitoring by investors and regulators, and have a more complete internal control system. Therefore, the impact of earnings management behavior in large companies may be responded to differently by the market compared to small ones. This suggests that firm size is likely to be a moderating factor in the relationship between earnings management and firm value, similar to managerial ownership (Latifah & Novitasari, 2021; Subanidja et al., 2016) or audit quality (Tarmidi & Murwaningsari, 2019). Therefore, the research hypothesis is proposed as follows:

H3: Firm size has a moderating role (+/-) in the relationship between earnings management and firm value.

3.3. Financial leverage and firm value

According to agency theory, financial leverage can be an external monitoring tool that helps minimize managers' behaviors that harm shareholders' interests, thereby promoting the goal of maximizing firm value (Jensen, 1986). Rizqia et al. (2013), Listiani & Supramono (2020) have demonstrated the ability to use financial leverage to enhance the firm value of listed manufacturing companies in Indonesia. Based on agency theory and previous research evidence, the following hypothesis is proposed:

H4: Financial leverage has a positive (+) impact on firm value.

3.4. Growth opportunities and firm value

High growth rates help firms access capital markets easily because investors perceive positive signals for these firms, so positive reactions reflect increasing firm value (Lumapow & Tumiwa, 2017). According to signaling theory, asset growth can become an important indicator for investors to evaluate the development prospects of a firm (Ehie & Olibe, 2010). Therefore, firms with stable asset growth over the years will be highly valued by investors, thereby increasing firm value. Data et al. (2017), Yahya et al. (2024) also agreed that growth has a positive impact on firm value. Based on signaling theory and previous research evidence, the following hypothesis is proposed:

H5: Growth opportunities have a positive (+) impact on firm value

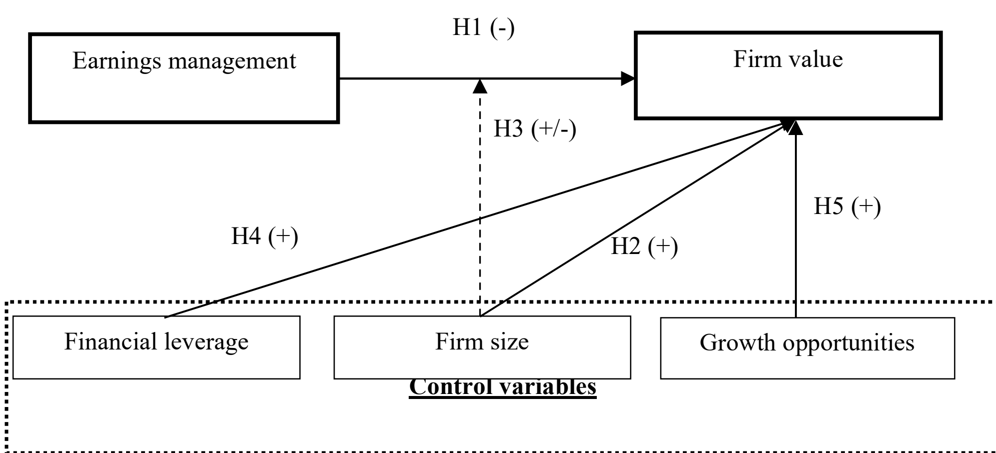

Figure 1: A model of the impact of earnings management on firm value

4. Conclusion

This study aimed to develop a comprehensive conceptual framework to dissect the complex relationship between earnings management and firm value. By integrating theoretical lenses from agency theory and signaling theory, the framework provides a solid basis to explain why previous empirical evidence on this relationship has been inconsistent. The focus of the paper is to propose firm size as a key moderator variable that can shed light on these inconsistent results. Specifically, we expect that the negative impact of earnings management on firm value will be significantly reduced in large-sized firms, where transparency, effective monitoring mechanisms, and market reputation may allow the market to interpret earnings management behavior in a less negative light, even as an information transmission device.

5. Theoretical Implications and Research Limitations

This study contributes to the literature by integrating agency theory and signaling theory to explain the contradictory findings regarding the effect of earnings management on firm value. It emphasizes firm size as a key moderating factor, suggesting that larger firms - characterized by better monitoring mechanisms and stronger market transparency - may face a different investor reaction to earnings management compared to smaller firms.

Despite its contributions, this study remains conceptual and has not yet been empirically tested. Future research should validate the framework using longitudinal data and address potential endogeneity issues. In addition, other contextual factors such as corporate governance quality, ownership structure, or regulatory environment may further moderate the earnings management - firm value relationship and warrant future examination.

Note:

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