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Financial and Social Performance Impact on Corporate Governance Mediated by Earnings Quality: Evidence from Indonesian Islamic Stocks

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Abstract

Good Corporate Governance (CG) ensures the availability of better accounting information with higher transparency and accountability. Implementation of good CG in Islamic stock issuers should have a more positive impact than non-Islamic stock issuers as the former are selected based on a strong financial fundamental. This study aims to empirically examine the impact of CG on earnings quality. It also examines the impact of earnings quality on firm's value. Thus earnings quality is considered as a mediating variable. This study uses the Structural Equation Model (SEM)-Partial Least Square (PLS). The final sample consists of 58 firms-years listed in Jakarta Islamic Index (JII) from 2008 to 2015. The study found that CG directly affects firm value with a positive direction. CG also increases earnings quality. The better the quality of CG, the better the quality of earnings. Then earnings quality increases firm value. In summary, earnings quality partially mediates the relationship between CG and firm's value. This study uses the Corporate Governance Performance Index (CGPI) published by IICG (the Indonesian Institute for Corporate Governance) as the indicator of corporate governance quality. Predictability, neutrality, timeliness, and earning smoothness are used as the indicators of earnings quality. Tobin's Q and corporate social performance represent firm value.

Keywords: Corporate governance, Islamic stock, Earnings quality, Corporate social responsibility, Islamic accounting

1. Introduction

The public demand for alternative *Shari'ah* investments to enter the capital market comes along with the development of Islamic economics and finance, especially in the banking and *Shari'ah* insurance sectors. The government responded with the introduction of Islamic mutual funds in mid-1997. In mid-2000, the Indonesia Stock Exchange (IDX) and PT. Danareksa Investment Management launched the Jakarta Islamic Index (JII) to guide investors who wish to invest their funds based on Islamic principles. Then the next six years precisely in March 2003 the *Shari'ah* Capital Market was formalized after it was agreed by Bapepam and DSN-MUI (Bapepam, 2011). A number of Islamic investment instruments have a legal basis of no less than 17 fatwas of the National *Shari'ah* Board (DSN) related to capital markets and *Shari'ah* transactions (MUI, 2016).The presence of JII is not only as an investment alternative that increases investors' confidence to invest in *Shari'ah* equity. With JII it is expected to attract potential investors who have not been involved in the capital market because of concerns that their investment is contrary to *Shari'ah* principles. JII is intended as a benchmark in assessing the performance of a *Shari'ah*-based stock investment. In addition to Islamic legal criteria, JII is selected based on fairly strict accounting and financial aspects, which shows strong financial fundamentals. Thus, the performance of shares that enter the JII should be very good so that it will be able to attract more investors to invest.

However, the development of the *Shari'ah* capital market until the end of 2014 has not reached a significant portion of the capital market industry. The value of Islamic products such as *sukuk* and Islamic mutual funds in circulation are still below 5% compared to the total products (*Shari'ah* and conventional)

(Financial Services Authority (OJK), 2015). The low number of investors making transactions in the Islamic capital market is more or less influenced by the low number of investors as a whole. Based on data recorded by PT. Indonesian Central Securities Depository, until the end of December 2018, the number of active investors in the Indonesian capital market was only around 1.6 million investors or less than 1% of the total 265 million Indonesian populations. Comparatively this percentage is lower than Singapore's 26% and Malaysia's 7.8% (The Jakarta Post, 2019).

In addition, the cause of the slow development of the Islamic capital market is also seen from the government's relatively slow response (compared to other countries such as Malaysia). The government is not fast enough in capturing *Shari'ah* capital market opportunities through the mechanism of preparing and adjusting regulations. For example, the case of double taxation for *murabahah* transactions criticized by the *Shari'ah* financial industry, then neutralized (tax neutrality) after the enactment of Law No. 42/2009. Other obstacles faced include limited types of *Shari'ah* products in the capital market (number, variety and type of contracts), lack of education and socialization of the *Shari'ah* capital market to investors as well as good governance conditions and the investment climate in Indonesia in general which have not met the expectations.

As a miniature of business and economic activities, companies listed on the stock exchange have a higher public eye when compared to other companies. Therefore, in addition to maintaining financial performance, many companies are starting to consider their corporate social performance (CSP) to show to their stakeholders that the company has initiated various activities that will improve social welfare and the environment around them. It can also be used as a guarantee for stakeholders that the company has gained legitimacy in running its business so that the sustainability issue is not a major threat to the company.

The issue of business sustainability becomes a strategic problem faced by many companies. The higher public awareness of social and environmental conditions is also one of the other factors increasing attention to the issue. Online surveys conducted by Nielsen Global Corporate Responsibility Survey (2014) shows that on average globally, 55% of consumers prefer to buy products and services from companies that are committed to social and environmental issues. These results increased compared to 2012 (50%) and in 2011 (45%). Long-term goals become one of the reasons for the emergence of CSP. CSP emphasizes on outcomes and results on all company activities in managing their social and environmental interactions (Carrol, 1999).

Achievement of social performance cannot be separated from the function of corporate governance. If corporate governance is effective, it will be reflected in the company's increasing attention to issues related to corporate sustainability, such as social and environmental issues because it cannot be denied that these issues are currently one of the strategic issues in supporting the company's survival (Branco and Rodrigues, 2006; Ducassy and Montandrau, 2015).

Corporate Governance (CG) is defined as a system that functions as the director and controller of the company. The purpose of this system is to achieve a balance between the strengths and authorities needed by the company to ensure the sustainability of the existence of the company and as a form of accountability to its stakeholders. This study looks at the quality of CG with a broader framework as suggested by Tirole (2001) and Gillan (2006) which is beyond the balance sheet and society model stakeholders. Society stakeholders have a significant role with CG quality (Bottenberg *et al*., 2017). Out of all parties in society stakeholders, investors have more incentives to monitor the quality of CG. Within the agency framework, CG quality is intended to minimize adverse selection problems and possible moral hazard by managers and is a potential loss for shareholders (Tirole, 2001). Likewise, Bottenberg *et al*. (2017) believe that a good CG quality must provide adequate incentives for the level of management to pursue the interests of the company and shareholders, thus encouraging companies to use more efficient resources. Because of this high interest, it can be understood if investors respond or react with practices, environment and external factors that influence the effectiveness of CG quality.

Adverse selection and moral hazard in Islam can be reduced by the implementation of guided morality in the Quran. The implementation of *akhlaqul karimah* (noble character) in every aspect and business activities is a manifestation of the upholding of faith and piety, by observing a sound and comprehensive relationship, including the interests of stakeholders and the surrounding environment. The implementation of business activities guided by *akhlaqul karimah* is aimed at creating and maintaining goodness for all. As a goal of the provisions *of Shari'ah* is the realization of blessing and affection for the universe as the word of Allah SWT in the Qur'an (Surah Al-Anbiya: 107) "We sent thee not save as a mercy for the people".

According to Ibn Kathir (2004) through this verse, Allah SWT tells that He made Prophet (pbuh) as a mercy for the universe. In other words, He sent him as a mercy for His people. Ibn Kathir said that those who follow Prophet (pbuh) would receive mercy in the world and the hereafter. Whereas those who do not follow will get trials and dooms in the world and the hereafter. Hence the tangible manifestation of *Shari'ah* compliance is the achievement of the objectives of *Shari'ah* (*maqasid Shari'ah*) in the form of realization and maintenance of benefits in totality.

The application of CG with totality will make a company maintains its quality. Good CG quality, can be detrimental to adverse selection and moral hazard. Many researchers have observed market reaction to CG quality. Larcker *et al*. (2010) for an example, concluded that market reacted to regulations issued by congresses and the SEC regarding the quality of CG. Asbaugh-Skaife *et al*. (2006) in their study tested CG quality relationships with credit ratings. This credit rating information is an essential information for investors to assess the company's performance and risk. Likewise, Masulis *et al*. (2007) concluded that CG mechanism related explicitly to acquisition decisions was responded to by the market, which was indicated by changes in abnormal returns surrounding the announcement of acquisitions.

Chahine *et al*. (2012) proves that CG quality should positively influence the market. However, research related to CG quality is not always responded positively by investors. Kouwenberg and Phunnarungsi (2013) measures the influence of governance on market reaction in Thai companies and Lee *et al*. (2005) measures the effect of governance structures on market reaction in local Chinese companies. As a result, better CG quality has not been proven to be responded positively by investors. Research with similar results was conducted by Aman and Nguyen (2008) where the quality of CG measured using the CG index does not significantly affect portfolio returns on public companies in Japan. The subsequent research supports this conclusion by Michikazu (2015) that some CG structures have a negative impact on the market reaction.

The relationship between CG quality and firm value is not always consistent and this motivates this study to test CG quality with a different approach which looks at the possibility of an indirect relationship between CG quality and firm value through earnings quality. This logic of thinking is based on the view that investors find it easier to see, measure and evaluate output (reported earnings) than the process to achieve output (CG practice). Companies may apply proper CG, but this good CG quality will be responded positively by the market if proven to have an impact on reported earnings although many research proves that earnings numbers are vulnerable to managerial discretion (Hung, 2001). Therefore this study examines the mediating role of earnings quality in influencing the quality of CG on firm value.

Research on the relationship of corporate value with earnings quality is an exciting theme to study from time to time. Most studies use accruals as one measure of earnings quality. Sloan (1996) proves the market reacts with reported earnings as indicated by changes in abnormal returns. Richardson (2005) follows up on Sloan's research results that high accrual component causes a decrease in future returns due to the accrual reliability. Then Pincus *el al*. (2007) follow up on Sloan's findings (1996) with cross-country research settings. From these various studies, it can be concluded that the market, in this case, investors respond (positive or negative) to reported earnings information.

Unbalanced information can cause various problems according to the Agency Theory. Jensen and Meckling (1976) describe two problems that arise as a result of asymmetric information. First, moral hazard is a problem that arises if the agent does not carry out the tasks that have been agreed upon in the work contract. The second adverse selection is a situation where the principal cannot know whether a decision taken by the agent is truly based on information that has been obtained or occurs as negligence of duty.

Good CG practices within the agency theory framework are expected to control (reduce) moral hazard and adverse selection. So that the reported earnings information is far from the manager's manipulation for specific purposes. This profit information illustrates the actual performance of the company, has the information awaited by investors to assist in making decisions (investments). Profit information will also be more persistent with good CG practices.

The relationship between CG quality and earnings quality has proven decisive in most research. Sun *et al*. (2010), Alsaadi *et al*. (2017) and Marchini *et al*. (2018) prove that the existence of an independent board of directors and audit committee reduces earnings management behavior and reduces fraud to manipulate earnings quality. The role of CG in reducing the behaviour of opportunistic earnings management is carried out by Firth (2007) and Duh *et al*. (2009).

While the impact of CG on the increase in reported earnings quality through increased disclosure that has an impact on transparency in Malaysian public companies was examined by Wan-Hussin (2009). The study finds the higher the proportion of affiliate directors, the broader the level of disclosure. But the existence of independent directors and institutional investors is not positively related to transparency. The inconsistency of results related to the independence of directors due to the possibility of collusion between independent directors and managers, thus making the condition even worse.

Recent research developments in the CG area found that the actual relationship between CG quality and earnings quality is quite complicated. Hutchinson and Leung (2007) in their study examined the relationship of ownership structure with earnings management behaviour. However, the ownership structure is distinguished between low level and high level. Siregar and Utama (2008) in their research on public companies on the IDX analyzed and detected the motivation behind earnings management. They concluded that earnings management behavior tends to be efficient, not opportunistic and that governance structures have a significant influence on this type of earnings management. Companies with a high proportion of family ownership and non-business groups tend to prefer efficient earnings management.

Using the CG score issued by the Indonesian Institute of Corporate Governance, this study will prove this assumption by examining the direct and indirect relationship between CG, earnings quality, and the value of companies listed in the JII during the period 2008-2015 with the method of Structural Equation Model (SEM) -Partial Least Square (PLS).

The next section discusses the theoretical basis and the development of hypotheses. Then, the third section explains the research method, which includes the procedure for selecting samples, types and sources of data, methods of data analysis and operationalization of variables. Section four discusses the results of the study to be followed with a conclusion.

2. Corporate Governance, Earnings Quality and Firms' Value

The results of research that are inconsistent about the role of CG may be due to the large number of externalities that cannot be captured in the measurements used (Black *et al*., 2006). The following are some research results that are not in accordance with the hypothesis built:

a) Research conducted by Chang and Sun (2009) on the effect of CG disclosure on earnings information and earnings management. When this study was conducted before the SOX period, independent boards and independent audit committees were negatively related to earnings management, but on the contrary, when testing was conducted after the SOX period, the direction of the relationship became positive. This proves the presence of SOX improves the effectiveness of CG functions in monitoring the quality of accounting earnings. SOX as an external CG variable is not captured in the composition of the board of directors.
b) Chena *et al*. (2007), that there is a negative relationship between the independence of the board of directors and the practice of earnings and relationship management is stronger when the Corporate Governance Best-Practice Principles (CGBPP) are applied to public companies in Taiwan. This is where the role of regulation (external dimension of CG) decreases the possibility of CG practice.
c) According to Cornett *et al*. (2008), the impact of CG on company performance will depend on performance measurement systems. The manager's earnings management behaviour will decrease along with the presence of independent and outside directors if the company applies for option compensation.
d) Machuga and Teitel (2009) prove that using broad-level CG without considering the legal and cultural environment will limit the impact of change due to CG. In Mexico, ownership structures are more dominated by family ownership, legal protection and weak property.

These externalities are tried to be captured in a comprehensive CG model. Gillan (2006) suggests that a multidimensional model of CG is referred to as beyond the balance sheet model. In the proposed model, the internal dimension of CG as a nexus of contract that involves the relationship of the board of directors-management, shareholders, creditors, employees, customers and suppliers. While the external dimension includes law or regulation, market forces, politics, cultures and communities. According to him the full picture of CG must touch both dimensions. The same is proposed by Tirole (2001) with his modern economic theory model that the CG mindset that has been focused on shareholder value since the 18th century needs to be aligned with the stakeholder society through its design of governance structures.

For economists and legal experts, the concept of shareholder value seems to be inharmonious, because

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manager's decisions not only affect investors but also wider stakeholders who have an innate relationship with the company: employees, customers, suppliers, communities where the company is located and affected by pollution generated. However, the number of variables with various measurement methods in multidimensional CG models, causes this model to experience problems in its use. Thus, the use of the CG index is one solution that represents a variety of variables in one value.

Some studies that use CG indexes such as Nicolo *et al*. (2008) use the CGX index which consists of 3 indicators: accounting standards (AS), earning smoothing (ES) and stock price synchronicity (SPS) based on accounting and market data from the Worldscope Database and Datastream. Jiang *et al*. (2008) also used CG scores, concluding that CG which was measured using a self-developed score was positively related to earnings quality. The higher the CG score, the lower the level of discretionary accrual and the higher the earnings quality. The results of his research also prove that the weaker the CG, the greater the tendency to make earnings management to adjust or exceed analysts' forecasts.

2.1 Corporate Governance and Earnings Quality

Baker and Wallage (2000) in their conceptual model conclude that financial statements that are part of the financial reporting system will remain relevant because they are one of the determinants of the functioning of good capital market. In addition, the right CG system requires an effective financial reporting system. Duh *et al*. (2009) prove that effective governance mechanisms can prevent earnings management behaviour that will affect the quality of earnings related to the reversal of loss assets. Ahn and Choi (2008) examined the impact of monitoring the behaviour of earnings management in the banking sector. They concluded that generally there is a decrease in earnings management behaviour when there is an increase in monitoring. The impact of CG on the improvement of earnings quality reported through increased disclosure that has an impact on transparency in Malaysian public companies was examined by Wan-Hussin (2009). His finding is that family ownership tends to discriminate all the principal items for segment reporting. The higher the proportion of affiliate directors, the wider the level of dislocation. But the existence of independent directors and institutional investors is not positively related to transparency. Furthermore, the researcher suspects that the inconsistency of results related to the independence of the directors is due to the possibility of collusion between independent directors and managers, thus making the condition even worse.

Firth *et al*. (2007) examined how ownership, the structure of the two-tier board of directors and auditors influences earnings information on publicly listed companies in China. Two measures of informativeness are used, namely earning response coefficients and discretionary accruals. The results of their study prove that the dominant type of shareholders and the size of the supervisory board and the percentage of independent directors have an impact on the frequency of modified audit opinions.

Two studies with the same research construct using different samples produced the same conclusions. Chung *et al*. (2002) used 1998 to 1996 data from Compact D/SEC databases; Koh (2003) used a sample of companies in Australia, both of these studies proved the relationship between institutional ownership and aggressive earnings management strategies. His finding is that there is a non-linear relationship between institutional ownership and discretionary accrual behaviour that increases earnings. More specifically, this study concludes that short-term and low-level investor ownership and low ownership cause managers to be motivated to increase earnings management. Monitoring conducted by investors with long-term ownership and high-level of ownership limits managers to earnings management. Velury and Jenkins (2006) using earnings quality measures based on the qualitative characteristics of financial statements, prove that there is a positive relationship between institutional ownership and earnings quality. However, there is a negative relationship between concentrated ownership and earnings quality.

Recent research developments in the CG area are able to detect that the actual relationship between CG and earnings quality is quite complex (not just monotonous). Hutchinson and Leung (2007) concluded that there were many factors that led to the strengthening or weakening of the magnitude of the relationship between ownership and earnings management behaviour, such as the existence of information asymmetry, company size, growth opportunities and other dimensions of CG.

Singh and Davidson (2003) examined the relationship between ownership structure and agency cost. They separate samples of American companies into large and small companies. In large companies, large inside ownership aligns the interests of managers and shareholders and lowers agency costs as measured by

asset utilization. But when the size of agency costs uses discretionary expenses, the results are not significant. The relationship between discretionary expenses that is not directly observable about the impact on cash flow (unlike sales revenue) and is not influenced by ownership causes this insignificant relationship. This finding is not proven in small companies, where the monitoring mechanism is carried out more by lenders - more dominated by banks.

Park and Shin (2002) also proved that CG mechanisms are not always related to earnings management practices. Outside directors do not reduce abnormal accruals overall, but directors of financial intermediaries and institutional shareholders who actively reduce earnings management behaviour. Different conclusions from most research results related to CG are influenced by a country's jurisdiction system, especially in Canada, where there is a concentration of ownership and the labour market for outside directors has not been well developed.

Habbash (2019) found the existence of independent directors can moderate earnings management behavior. The role of independent directors will be more effective if at least 1/3 of the entire board. Big 4 audits can limit earnings management behaviour, but there is no significant relationship between centralized or concentrated ownership with discretionary accruals.

Yang *et al.* (2008) in their study on Taiwanese companies found that ownership of inside directors is classified into executives, outside directors and block-holders. During the 1997-2004 observation period, discretionary accrual experienced an increase in pattern and then decreased with the presence of executive ownership forming a U-curve. However discretionary accrual was positively related to the ownership of the board of directors and block-holder ownership.

Demirka and Platt (2009) extended a research on the role of CG on earnings management behaviour which is separated between healthy and distressed companies. The results are like many other studies, that CG has a significant effect on discretionary accrual when CG is measured using an index. Strong CG tends to reduce discretionary accruals. But in companies that experience distress, the relationship between CG and accrual discretionary is found to be weak.

From the review above, this study hypothesizes that, H1: There is a relationship between corporate governance and earnings quality.

2.2 Corporate Governance and Firms Value

Larcker *et al*. (2010) concluded that investors reacted to regulations issued by the congress and SEC related to CG. The regulations observed are related to executive compensation restrictions, the CEO-chairman duality and other regulations. By using the event study, their study proves that there is a change in abnormal returns from before and after the regulation was approved. Asbaugh-Skaife *et al.* (2006) examined CG relations with credit ratings. They concluded that the company's overall credit rating is negatively related to the number of block-holders whose ownership is at least 5%, positively related to the independence of the board of directors, share ownership by the board of directors, directors expertise and negatively related to the influence of the CEO on the board of directors. This credit rating information is an important information for investors to assess the company's performance and risks. Masulis *et al*. (2007) highlighted the CG mechanism in relation to acquisition decisions that the market responded to with proven abnormal return changes surrounding the announcement of acquisitions. Companies with strong anti-takeover policies experienced lower abnormal returns around the announcement.

Alexander *et al*. (2007) and Haron (2018) examined the impact of CG on corporate firm value and concluded a significant influence of CG on firm value. Alexander *et al.* (2007) recorded that weak CG structure lowers the value of a company and company value will increase with a good CG structure. In addition, the number of institutional owners has a positive relationship with abnormal returns of the firm. Meanwhile, Hooper *et al.* (2009) examined the effect of CG on cross-country stock markets performance. From a governance perspective outside the organization, viewed from the legal and political aspects, the level of corruption of a country and accountability, determines the quality of CG companies in the country. Countries with good governance systems will improve market performance in terms of the monthly return index and reduce risk, both systematic and non-systematic risks. They then concluded that the condition of capital market development leads to a good CG system and will further increase overall market return.

However, research related to CG does not always respond positively by investors. Lee *et al.* (2005) measured governance structures with five variables and looked at their effects on investors' reactions in

local Taiwanese companies. The hypothesis is that investor reactions to earnings reported by public companies are higher for companies with good CG practices were not proven. His study uses an event study that observes abnormal returns around the 5-day announcement of annual earnings. The finding supports the need for comprehensive instruments to capture good CG practices. In addition, the condition of China's capital market with infrastructure that has not been well developed may cause information not to be properly disseminated to investors. Thus this causes the response rate of investors to information relatively slow compared to capital markets in developed countries. The research with similar results was done by Aman and Nguyen (2008), where CG, as measured by the index, does not significantly affect portfolio return in public companies in Japan. Even companies with high index values (low) obtained a low return value (high). They criticized the conflicting results related to the risk-return tradeoff. A high index shows good governance so as to reduce risk, which in turn has an impact on decreasing returns.

Rankin *et al*. (2011) found that governance has an important role in the company's social performance. Management as the subject of CG plays an important role in managing and sorting and choosing social activities that are relevant to the company. Companies with good governance will have an impact on their social and environmental performance because the company assumes that this is relevant for the survival of the company. Habbash (2019) said that information about the company's social performance is a strategic information because this information reflects how management responds to external pressures related to environmental sustainability and impacts on surrounding communities.

In disclosing or taking an action related to the company, management will consider the costs to be borne and the benefits to be achieved. Social and environmental issues are one of the important things facing the management. Therefore, management or the board of directors and commissioners will use all their abilities, knowledge and interpretations when deciding and supervising a policy regarding their social and environmental accountability (Lewis *et al*., 2014).

Based on the literature review, hypothesis 2 was developed i.e. H2: There is a relationship between corporate governance and firm value.

2.2 Earnings Quality and Firms Value

Sloan (1996) found investors reacted on reported earnings. This reaction is indicated by changes in abnormal returns. Furthermore, Sloan (1996) identified that investor's reaction was more due to the cash flow component contained in earnings than the accrual component. If the accrual component in profit is high, future returns will decrease. This is due to at least two aspects i.e. (1) the occurrence of cancelling out processes as a result of accruals and (2) accrual content has a high subjectivity so that the risk of investment uncertainty is also relatively high. Richardson (2005) elaborated the results of Sloan's (1996) that the high accrual component causes a decrease in future returns due to the reliability of the accruals. Less reliable accruals relative to the decrease in future returns compared to more reliable accruals. From these studies, it can be concluded that the market, in this case, investors respond (positive or negative) to reported earnings information.

Companies that have higher earnings quality are expected to have better social performance because they will carry out investments regarding CSR activities in real terms and are more effective than companies that have lower earnings quality. This is supported by the findings of Habbash (2019) that the lower the earnings quality of the company, the company has a tendency to invest in areas that have high discretion, such as ineffective CSR programs. Based on the explanation, the third hypothesis is: H3: There is a relationship between earnings quality and firms value.

2.4 Corporate Governance, Earnings Quality and Firm Value

Mir and Seboi (2006) examined the role of CG in bridging the gap between accounting value and created shareholder value. Accounting value in their study is measured based on the Economic Value Added (EVA) and market value using the Created Shareholder Value (CSV). Through the CG mechanism, managerial earnings management behavior can be reduced so that the gap between accounting value (EVA) and market value (CSV) is getting smaller. From the explanation of CG's direct relationship and firm value and earnings quality and firm value, the fourth hypothesis is, H4: There is a relationship between governance

and corporate value through earnings quality.

3. Research Methods

3.1 Sample and Data

The purpose of this study is to determine the direct and indirect relationship between CG and market reaction. This research uses purposive sampling method. The criteria are:

a) The company is registered in the Jakarta Islamic Index (JII) from 2008-2015.
b) The company is listed in the Corporate Governance Perception Index (CGPI) from 2008-2015.
c) Having complete financial and non-financial data which is needed in this study.

This study uses panel data from 2008 to 2015. The data required are secondary data, i.e. financial report, annual report, and company sustainability report. The use of secondary data can increase the variability thus decreasing the multi-collinierity among the variables studied (Haron, 2016). All data on each company is obtained from IDX website. This study uses CG score data obtained from CGPI by the Indonesian Institute of Corporate Governance (IICG).

3.2 Variables

This study uses path analysis. Therefore, the types of variables in this study were divided into two, endogenous and exogenous variables. Endogenous variables are dependent variables on at least one equation in the model (Wijanto, 2015). Endogenous variables in this study are firm value (PR) and earnings quality (EQ). Exogenous variables are independent variables in all equations that exist in the research model (Wijanto, 2015). Exogenous variables in this study are corporate governance (CG) and earnings quality (EQ). Explanation of each variable is as follows:

3.2.1 Corporate Governance (CG)

This study uses the CG index to describe the quality of CG. Previous research conducted by Nicolo *et al*. (2008) and Jiang *et al*. (2008) also used the CG index. The index is expected to provide a comprehensive and multidimensional picture of CG as suggested by Tirole (2001) and Gillan (2006). The CG index used in the study is the index issued by IICG. IICG issued a ranking in governance in Indonesia as the CGPI Index has a scale of 1-100, the higher the value of CGPI index shows the better the quality of CG. The IICG categorizes the listed CGPI award issuer scores into three categories: A (very reliable) 85.00-100.000, B (trusted) 70.00 - 84.99 and C (quite reliable) 55.00 - 69.99.

3.2.2 Earnings Quality (EQ)

EQ in this study is using the measurement adopted by Velury and Jenkins (2006). This measurement is chosen because the consideration is more comprehensive. It not only incorporates manager's discretion elements that are widely used and contain many weaknesses (DeFond, 2010), but also the persistence and accuracy of the information. The proxies of earnings quality are described as follows:

a) Predictive value or feedback value is using cash-flow –earning relationship, the formula is:

$CFO_{i(t+1)} = \alpha_0 + \alpha_1 OPIN_{i(t)} + \varepsilon_{i(t)}$

where:

$CFO_{i(t+1)}$: Cash flow operation divided by total assets of firm *i* at year end *t* + 1

$OPIN_{i(t)}$: Operating Income divided by total assets of company *i* at year end *t*

b) Neutrality is using magnitude abnormal return, the formula is:

$TA_{i,t} / Ai_{,t-1} = [\alpha_i (1/Ai_{,t-1}) + \beta 1_i (\Delta REV_{i,t})/A_{i,t-1}) + \beta 2i (PPE_{i,t}/Ai_{,t-1})] + \varepsilon_{i(t)}$

where:

$TA_{i,t}$: Total Accrual (Net Income before extra-ordinary items minus Cash flow)

$Ai_{,t-1}$: Total asset for *t-1*
$\Delta REV_{i,t}$: Changes in revenue from year *t-1* to year *t*
$PPE_{i,t}$: gross value of property, plant and equipment
ε : Error term (which reflects the magnitude of abnormal return)

c) Timeliness is using reporting lag from the end of the fiscal year to the submission date.
d) Earnings Smoothness is using the standard deviation value of the firm's profit growth.

e) Firm Value
i) Financial Performance: Tobin's Q, namely:

$$\frac{Book\ Value\ of\ Asset - Book\ Value\ of\ Equity + Market\ Value\ of\ Equity}{Total\ Assets}$$

ii) Non-Financial Performance: Corporate social performance, measured using content analysis of corporate social responsibility reporting (CSR), based on the fourth generation (G4) of Global Reporting Index (GRI). This indicator covers 3 criteria, economic, social, and environmental. There are 9 indicators in the economic criteria, 48 indicators in social criteria, and 34 indicators in environmental criteria. Furthermore, to calculate the company's social performance, the total score for indicators reported per firm is compared to the maximum total score. The formula is as follows:

$$CSP_i = \frac{SCSP_i}{SCSPMAX} \times 100$$

where:
CSP_{it}: Corporate social performance *i*
$SCSP_i$: Corporate social performance score *i*
SCSPMAX: The maximum score of social performance (9 + 48 + 34 = 91)

3.3 Research Model

To answer hypotheses 1 to 4, the following research models are used:

H1: There is a relationship between CG to earnings quality
$EQ_{it} = \alpha_0 + \alpha_1 CG_{it} + \varepsilon_{it}$
H2: There is a relationship between CG on company performance
$PR_{it} = \beta_0 + \beta_1 CG_{it} + \varepsilon_{it}$
H3: There is a relationship between earnings quality on company performance
$PR_{it} = \gamma_0 + \gamma_1 EQ_{it} + \varepsilon_{it}$
H4: Earnings quality is able to mediate CG relationships with company performance
$\beta_1 * \gamma_1 > \alpha_1$

3.4 Data Analysis

This study uses path analysis which shows the direct and indirect effect of a set of independent variables on the dependent variable. To support the analysis, this study uses technical analysis of SEM-PLS data by using WarpPLS application. SEM-PLS has advantages over other SEM analysis methods (such as Covariance Based Structural Equation Model). Latan and Ghozali (2013) revealed that complex models (exogenous and endogenous variables with multiple indicators), small sample size, and data types varied, would be more appropriately analyzed with SEM-PLS. Path analysis was used in this study to examine the indirect relationship of CG to firm value through earnings quality, as well as the direct relationship between CG and firm value. Figure 1 illustrates the path diagram.

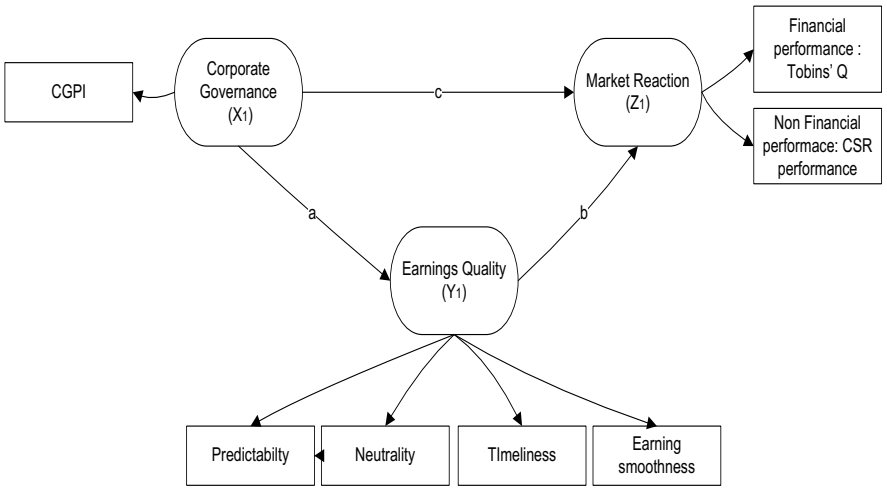

Figure 1: Conceptual Model

The next step is to perform the analysis with SEM-PLS. There are two stages in the SEM-PLS procedure (Wijanto, 2015) as follows:

a) Confirmatory Factor Analysis (CFA): performs a confirmatory factor analysis to determine the validity of the indicators that make up the exogenous latent variable in the study by looking at the VIF (Variance Inflation Factor) value.
b) Structural Model Test: to test the significance of exogenous latent variables (independent) to endogenous latent variables (dependent) and values of R^2.

4. Results and Discussion

4.1 Sample Description

The population in this study are all companies listed in IDX and Jakarta Islamic Index during the period of 2008-2015. To get representative sample of research, purposive sampling is performed and based on the sample selection, the sample in this study is as follows:

Table 1: Sample Selection Criteria

Sample Selection Criteria	**Number of Observations (Firms-Years)**
Registered in JII for 2008-2015	240
Participated in CGPI Award for 2008- 2015	83
Incomplete data	(25)
Number of Observations (Firms-Years)	58

Based on the sample selection, there are 240 observations listed on JII (30 companies multiplied by 8 observation periods). Furthermore, there are 83 observations that follow the CGPI during the period 2008-2015. After tabulating the data, 25 observations were found that lacked complete data (no information or annual reports and / or sustainability reports were reported, so data for the firm's value variable based on its social performance was not available) so it should be excluded in the research sample. The final data in this study is 58 observations.

4.2 Descriptive Statistics

Descriptive statistical analysis in this study include the mean (average), standard deviation (minimum deviation), the minimum and maximum value of the research variables as presented in Table 2.

Table 2: Descriptive Statistics

Variable	Minimum	Maximum	Average	Std. Dev
CG	66.510	90.580	82.269	4.917
EQ				
Neutrality	-0.025	1.117	0.158	0.174
Earning smoothness	8.733	15.997	13.261	1.398
Predictability	6.293	21.457	13.391	1.879
Timeliness	52	123	84.207	19.098
Firm Value				
Financial	0.297	1.988	1.309	0.394
Non-Financial	1,25	91,21	33,72	24,34

Based on Table 2, the CG included in the research observation has an average value of 82.269. This indicates that the average company listed on JII has a trusted governance value because it is in the range between 70.00 and 84.99. The minimum value of this variable is 66,510 (quite reliable), the maximum value is 90,580 (very reliable) and the standard deviation value is 4,917. Earnings quality has four indicators; neutrality, earning smoothness, predictability, and timeliness. Neutrality has an average value of 0.158 with a minimum value of -0.025, a maximum value of 1.117 and a standard deviation of 0.174. Earnings smoothness has an average value of 13.261 with a minimum value of 8.733, a maximum value of 15.997 and a standard deviation of 1.398. Predictability has an average value of 13.391 with a minimum value of 6.293, a maximum value of 21.457 and a standard deviation of 1.879. Timeliness has an average value of 84.207 with a minimum value of 52, a maximum value of 123 and a standard deviation value of 19.098.

Firm value is measured by two measurements, financial and non-financial performance. Financial performance is measured by Tobins' Q. The average value of financial performance is 1.309, the minimum value is 0.297, the maximum value is 1.988, and the standard deviation is 0.393. Non-financial performance is measured by the social performance score of each company. The average value of nonfinancial performance is 33.72, with a minimum value of 1.25, a maximum value of 91.21, and a standard deviation of 24.34.

4.3 Model Measurement Testing

It is conducted to test whether the model used has fit with sample data or not. The results of model fit measurement test in this study is based on VIF (Variance Inflation Factor). The results of this test are summarized in Table 3.

Table 3: Model Measurement Test

Model Measurement Fit Tes	Target Fit	Estimated Result	Conclusion
Average Block VIF (AVIF)	≤ 3,3 - 5	1,109	Perfect fit
Average full collinearity VIF (AFVIF)	≤ 3,3 - 5	1,650	Perfect fit

Based on the VIF test results, the matching value of the measurement model in the research model shows a value less than 3.3, 1.109 (AVIF) and 1.650 (AFVIF). The results indicate that the measurement of this research model is compatible with the research data and can proceed with further testing (structural model / hypothesis).

4.4 Hypothesis Testing

Hypothesis testing in this study employed SEM-PLS method using WarpPLS application. The summary of the structural model significance test results are shown in Table 4 below:

Table 4: Test Results Significance of Structural Research Model

Relationship between Variables	**Coefficient.**	**p-value**	**Result**
H1: CG to EQ	0.70	0.001	H1 accepted
H2: CG to PR	0.40	0.001	H2 accepted
H3: EQ to PR	0.32	0.003	H3 accepted
Relationship between Variable	Coefficient.	*p-value*	Result
H4: CG to PR mediated by EQ	(CG-EQ)* (EQ-PR) 0.70*0.32 = 0.22	significant	H4 rejected (0.22<0.40) (partially mediation)

The output of this research testing can be seen in Figure 2 below:

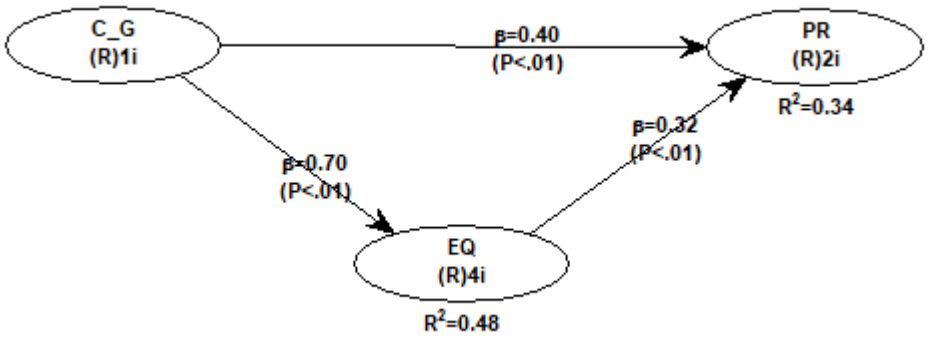

Figure 2: Output of Structural Test Model

Based on Table 4 and Figure 2, the path coefficient between governance (CG) and earnings quality (EQ) has significant p-value (less than 0.01). The relationship shows a positive direction with a coefficient value of 0.70. Based on these results, it can be concluded that there is a positive relationship between CG and EQ. These results supported the first hypothesis in this study.

The result of path coefficient between governance (CG) and firm value (PR) shows significant result with p-value (less than 0.01). The relationship has a positive direction with a coefficient value of 0.401. Based on these results, there is sufficient evidence to accept the second hypothesis. These results indicate that CG will increase corporate value.

The third hypothesis examines the relationship between EQ and PR. Based on Table 3 and Figure 1, the p-value between the two variables is significant (less than 0.01). The direction of the two relationships is positive, so this study provides sufficient evidence to accept the third hypothesis. These results indicate that the better the earnings quality, the higher the firm value.

The final hypothesis is to examine the role of earnings quality in mediating the relationship between CG and PR. Although the effect is significant, based on the path analysis, this study cannot provide sufficient evidence to support this hypothesis because the magnitude of this coefficient is not greater than that of direct relation between CG and PR (0.22 <0.40). Based on these results, it can be said that EQ cannot mediate the relationship between CG and PR.

Based on these results, the value of R^2 on the latent variable of PR is 0.34 or 34%. While the value of

R^2 on latent variable of earnings quality (EQ) is 0.48 (48%). The results show that both latent variables can be explained with exogenous variables in this study of 34% and 48%. Discussion of each hypothesis is described as follows.

4.4.1 Good Corporate Governance and Earnings Quality

The first hypothesis in this study is that, there is a relationship between CG with the quality of EQ. The result shows that the relationship is significant with coefficient value of 0.70 and p-value (less than 0.01). Based on these tests, the first hypothesis is accepted because there is sufficient evidence to conclude that the better CG will result in better EQ. One of the principles of good CG is transparency, including the transparency of financial statements. The transparency of these financial statements will reduce the potential of moral hazard which will then impact on improving EQ. Baker and Wallage (2000) concluded that the financial statements that are part of the financial reporting system will remain relevant as it becomes one of the determinants of the proper functioning of the capital market. In addition, an appropriate governance system requires an effective financial reporting system. The positive impact between the CG with EQ depicted in this study supports Ahn and Choi (2009) which examine the impact of monitoring on earnings management behavior in the banking sector. They conclude that in general there is a decrease in earnings management behavior when there is increased monitoring (an increase in CG functions) so that reported earnings are more qualified.

4.4.2 Corporate Governance and Firm Value

The second hypothesis in this study is that there is a relationship between CG and firm value. The results show that the relationship is significant with coefficient value of 0.40 and p-value (less than 0.01). Based on these tests, the second hypothesis in this study is accepted because this study has sufficient evidence that the better corporate governance will increase firm value. Larcker *et al*. (2010) said that the market will react to regulations issued by Congress or SEC related to CG quality. In line with these statements, the results of the study show that with increasing CG scores (CGPI), the value of the firm will increase. The results of this study also support the study of Alexander *et al*. (2007) which examines the impact of the announcement of governance policies on corporate value. Poor CG structures will degrade firm value whereas firm value will increase with good governance structure.

4.4.3 Earnings Quality and Firm Value

The third hypothesis in this study is that there is a relationship between the earnings quality and firm value. The results show that the relationship is significant with the coefficient value of 0.32 and p-value (less than 0.01). Based on these tests, the third hypothesis in this study is accepted because this study has sufficient evidence that the higher earnings quality will increase firm value. Earning is one form of management business achievements in a commercial company. Whatever form of reported earnings, it will generate a reaction to the market (Sloan, 1996). However, the market will be more specific to analyze reported earnings. As claimed by Richardson (2005), the high accrual component causes the decline in future return is more due to the reliability accrual. Accruals that are less reliable relative impact on future return decreases compared to more reliable accruals. Earnings quality becomes one indicator of market reaction so that the market can provide an assessment of the performance of a company. The results of this study indicate the influence between earnings quality and firm value. The better the earnings quality which reported by the company, will increase the value of the firm. These results are also in line with Alexander *et al*. (2007) and Larcker *et al*. (2010).

4.4.4 Corporate Governance, Earnings Quality and Firm Value

The fourth hypothesis in this study is that earnings quality can mediate the relationship between CG and firm value. The results show that the relationship is significant. However, based on a comparison between direct influence (CG and firm value) of 0.40 and an indirect effect of 0.22 (0.70 0.32). The indirect effect of

CG quality on firm value through mediation of earnings quality is lower with the coefficient value of 0.22, compared to the direct effect of CG on firm value with the coefficient of 0.40. Based on these tests, the fourth hypothesis in this study was rejected because the study lacked sufficient evidence that earnings quality could mediate the relationship between CG and firm value.

5. Conclusion

This study aims to examine the direct effect of governance on firm value and indirect influence by using the mediation of earnings quality. The study was conducted on 58 observations registered at JII during the period 2008-2015. The results show that directly, CG has an effect on firm value. While the earnings quality cannot mediate the relationship. These results indicate that governance has a very important role in creating firm value. This study also finds evidence that CG affects the quality of earnings, and the quality of earnings affects the firm's value.

This study has various limitations, such as research data due to the use of CGPI scores as a proxy of CG, and other data following the data of companies that have had the CGPI score. This limited data leads to testing using parametric statistics to undergo many adjustments to make assumptions before the tests are met. In subsequent empirical studies it is expected to use governance measurements with other models such as the self-developed CG scores of good CG elements or principles. Then this study has not considered the characteristics of the company, such as whether the company belongs to the group of green company so they really pay attention to issues of sustainability. It is hoped that further research will take into consideration some of the limitations of this research, which will add to the sciences of governance, earnings quality, and firm value.

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