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# Corporate Governance and Investment Efficiency: The Mediating Effect of Earnings Quality

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**Abstract**

The purpose of this research was to investigate the effect of corporate governance on earnings quality, corporate governance and earnings quality on investmentefficiency, and also the effect of corporate governance on investment efficiency mediatedby earnings quality. The theory used in this research is agency theory. Population used is the whole manufacture company listed in Indonesia Stock Exchange period 2018-2020. This study uses secondary data which are financial statement and annual report that published by IDX and official company's website. Sampling method used is purposive sampling method and obtained 42 companies for 3 years. The analytical method used is path analysis and hypothesis mediation analysed by using sobel test. The result of analysis shows that corporate governance has a positive and significant effect on earningsquality. Earnings quality have positive and significant effect on investment efficiency, corporate governance has a positive but not significant effect on investment efficiency. This research also shows that earnings quality plays a role in mediating the effect of corporate governance on investment efficiency which is fully mediation.

**Keywords:** Corporate governance; earnings quality; investment efficiency

## 1 Introduction

Efficient investment decision-making is an important matter in supporting the sustainability of the company as well as for stakeholders in improving their welfare. Investment can be described as a company activity in allocating funds in a period that is expected to have a positive impact on the company in the future [1]. Investments made mustbe following the needs of the company [2]. Efficient investment can be realized through investment optimization. This provides an opportunity for the company to gain earnings in the future.

A company is said to be experiencing an inefficient investment condition if the company experiences a lack of funds to invest so that the company will be involved in large debts but has no guarantees to repay the loan (free cash flow). In addition, companies with high levelsof leverage have slow growth and have high free cash flow or excess capital so companies cannot invest optimally. Companies that have excess capital but do not place their capital properly and with a slow growth rate, the company will experience investment inefficiency conditions [3].

The parameter to determine the level of inefficiency of investment is reflected through the Incremental Capital Output Ratio (ICOR). ICOR numbers that are getting higher indicate that the incoming investment to encourage a country's economic growth is inefficient. In 2018, the ICOR rate in Indonesia was 6.44% which got worse in 2019 which showed a figure of 6.77%. This makes Indonesia have a fairly high ICOR when compared to neighboring countries such as Malaysia, the Philippines, Thailand, and Vietnam which are approaching the ideal ICOR figure of 3% [4].

The problem of investment inefficiency can be reduced if the company implementscorporate governance through healthier corporate practices and increases supervision and control measures to encourage management to produce accrual quality from higher earnings tomake efficient investment decisions. The results of previous research found that the efficiency level of corporate investment can be realized through better corporate governance practices implemented by companies [5, 6, 7]. This helps the company increase its growth of the company under the investment made. Better implementation of corporate governance means that the management of corporate resources can become more efficient, effective, and productive. Corporate governance in its main objective is to create a system of checks and balances to prevent the misuse resources and to show the growth of a company [8].

The application of good corporate governance in a company will affect optimal and appropriate investment actions for the company [9]. This will have a positive impact on the company in optimizing its investment. The implementation of corporate governance will also assist companies in obtaining financing funds more easily and improve company performance which can suppress slow sales growth rates to avoid investment inefficiency conditions.Previous studies have found a significant effect of corporate governance on investment efficiency [10, 11, 12, 13, 14].

Earnings information can be taken into consideration for companies in implementingmore efficient investments. Earnings information is also useful for measuring performance, assessing the effectiveness of resource utilization, and predicting company performance in the future [15]. Relevant earnings information can be used as a reference in predicting appropriate and useful investment planning in the future [2].

Earnings quality measure the extent to which the information presented in the financial statements shows the actual condition of the company [16]. Earnings quality for the current period will affect efficient investment in the next period [17]. This will assist managers in planning investments that provide long-term benefits for the company. Earnings information becomes a consideration for companies in making investments that are more efficient and useful for measuring performance, assessing the effectiveness of resource utilization, and predicting company performance in the future [15]. Previous studies have found that good earnings quality will have an impact on increasing investment efficiency [18].

Companies that have high earnings quality will show higher investment efficiency [8, 19, 20]. Higher earnings quality will be able to provide information about the characteristics of thecompany's financial performance which will lead to specific and precise decision-making [21].It is inconsistent to find that earnings quality does not affect the level of efficient investment for both companies experiencing underinvestment and overinvestment [22].

Good accrual quality can be obtained by implementing good corporate governance. Implementation of corporate governance principles will be the most effective control to oversee management actions [23]. By adhering to GCG principles, companies that have good corporate governance will be able to present information in an accurate, relevant, and timely manner so that the earnings information conveyed by the company will be trusted by investors. Good corporate governance will promote healthier corporate practices so that they can put pressure on managers to present earnings that reflect the real situation.

Corporate governance plays a role in creating earnings quality for making decisions that have the opportunity to provide long-term benefits for the company. The results of previous studies found that good corporate governance practices can improve earnings quality [24, 25, 26]. However, these results contradict the findings of good corporate governance as measured using the Corporate Governance Perception Index (CGPI) which has no significant effect on earnings quality [27].

The implementation of good corporate governance will promote healthier practices withinthe company and increase supervisory and controlling actions by members of the board so thatit will encourage the behavior of managers in presenting transparent and quality financial reports. Companies can make better use of the information obtained in carrying out their company operations. Earnings becomes information that plays an important role in decision- making by interested parties. Related to making efficient investment decisions, earnings information that reflects the actual situation will be an indicator in making optimal investment planning. Earnings quality in the presentation of financial statements can be put to good useby managers in the context of making optimal investment decisions.

This research is important to do considering the company wants the investment made tobe realized optimally. Role of good corporate governance will assist companies in protecting the interests of stakeholders so that appropriate and efficient investment actions can be taken through earnings quality information from management. In addition, good corporate governance will also improve the company's operational practices that are healthier towardsthe actions of providers of financial reports that have an impact on the quality of reported earnings. This study aims to investigate the effect of corporate governance on investment efficiency through earnings quality.

## 2 Theoretical Framework and Hypothesis Development

### 2.1 Theoretical Framework

Decision making especially in terms of investment can be more effective and efficient as a result of better corporate governance. The investment can be said to be efficient if the investment can be implemented optimally. Agency theory emphasizes the existence of a conflict between the principal and the agent which causes agents to generally make investmentdecisions based on their interests. The implementation of corporate governance can improve the company's operational practices in a healthier manner which will reflect better monitoring and control actions to control managers in making more efficient investment decisions to reduce agency conflicts that occur. In addition, it can encourage managers to produce financialreports that reflect earnings quality to help companies obtain funds more easily when companies experience funding difficulties when they want to take investment opportunities with positive projections. On the other hand, it also assists managers in determining investment that is not excessive (according to company needs) by taking into account the company's growth to avoid conditions of investment inefficiency.

One of the problems in agency theory, namely the emergence of information asymmetry can also be minimized through the implementation of corporate governance in connectionwith this role in improving the quality of accruals from earnings. With the emergence of information asymmetry between owners and managers, managers can carry out earningsmanagement for their interests without regard to the interests of the principals, so the implementation of better corporate governance is needed. This can improve company practicesin a healthier manner which will increase supervisory and controlling actions by board members to minimize managers' actions in presenting lower-quality earnings. However, the information asymmetry that arises can also be minimized by presenting a higher quality of earnings which indicates a higher quality of earnings serves as an indicator in determining an efficient investment in providing long-term earnings for the company.

Management often provides financial reports that are of less quality because they feel they are not the owner of the company so they take actions that are more profitable for their interests. Agency theory explains that there is a conflict of interest between the principal and the agent, giving rise to an agency conflict between the two parties. For the sake of making theright decision for the company, it will depend heavily on the balance of the relationship between the principal and the agent so that the agent can present financial reports through earnings quality to assist the owners in determining the decisions to be taken, especially regarding making investment decisions that are beneficial to the company. More relevant earnings information will show more accurate company conditions so that it can help companies pay attention to company growth under the required investment. This is useful for planning investments to be more precise and provide long-term benefits and earnings for the company. The increasing quality of earnings) presented by the company can naturally affect the increase in the efficiency of investment in the company.

On the other hand, the emergence of information asymmetry resulting from agency conflicts can also affect the relationship between earnings quality and the efficiency of a company's investment. More information owned by managers about the condition of the company will make it difficult for other stakeholders in supervising managers in determining efficient investment decisions for the future of the company. The difference in information acquisition between the two parties can be minimized by increasing the quality of the presentation of earnings in providing information about the actual condition of the company. Presentation of increasingly relevant earnings can help investment planning which provides increased sales growth and long-term benefits for the company to avoid investment inefficiency conditions. Thus, the higher quality of accrual earnings presented by the companywill reflect earnings management actions by managers will decrease so that financial reports can be presented in a better way for use in the decision making of interested parties.

In connection with agency theory which states that there is a conflict of interest and creates information asymmetry for the principal and agent can be minimized through the implementation of better corporate governance. Through the implementation of thismechanism, managers will be able to provide more quality earnings that it reflects an increase in the quality of accruals. This will provide more accurate information as an indicator in determining investments that have long-term profitable projects in line with increased sales growth resulting from the efficiency of these investments. Thus, investment decision-making can be as efficient as possible through accrual earnings that are increasingly qualified due to the implementation of corporate governance.

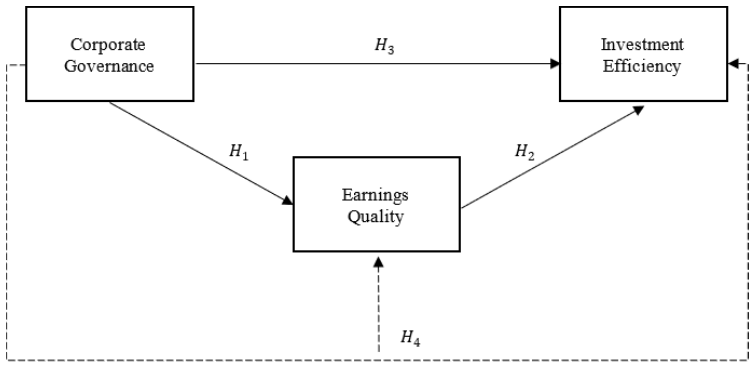


**Fig. 1.** Conceptual Framework

### 2.2 Hypothesis Development

A company that has better corporate governance will provide an increase in the company's relationship with stakeholders. This well-established relationship can create a balance for conflicts of interest to reduce agency conflicts within the company. This relationship also provides benefits for the company in creating more harmonious agency relationships, such as making the right decisions, presenting financial reports more transparently, and providing relevant information to the company. Better agency relations will promote healthier company practices and operational oversight. This will encourage managers to create quality earnings through the presentation of financial reports that provide more relevant information for the company's future earnings.

The implementation of better corporate governance can lead to an increase in company performance which will increase the quality of earnings [26, 28]. Corporate governance can encourage earnings to be generated that are more persistent, and the value relevance ofearnings is higher and more conservative in accounting information [29]. However, these results are inconsistent with findings that state that good corporate governance with theCorporate Governance Perception Index (CGPI) has an insignificant effect on earnings quality[30].

**$H_1$: Corporate governance has a positive and significant influence on earnings quality**

The accrual quality of earnings will show the company's ability to produce the company's financial statements. Management who transparently presents earnings will make decisions more efficient and provide higher earnings for the company in the future. High earnings quality reflects to provide an overview to decision-makers that the company can generate earnings from the company's operational activities. High earnings quality indicates morerelevant and reliable information for decision-makers as an indicator in determining efficient investment by considering the company's growth which can be seen in increasing earnings quality. This relevant and reliable information will help the company to avoid investment inefficiency.

The higher quality of financial reports will reduce information asymmetry to increase the efficiency of the company's investment [31, 32] and increase investor confidence [33]. Contrary to this, the quality of financial statements has an insignificant effect on the level of investment because of the desire of management to show the best investment performance andthe company's investment decisions may consider free cash flow more than the quality of financial reports [22]. Several previous studies have also found that earnings quality has a negative and significant effect on investment efficiency [3, 34].

**$H_2$: Earnings quality has a positive and significant effect on investment efficiency**

The implementation of better corporate governance can provide an overview for the parties responsible for making more efficient investment decisions where the investment is avoided from conditions of investment inefficiency. This can be reflected in better company monitoring and control practices to encourage management to make investment decisions that are in line with the company's sales growth. Good corporate governance also shows better operational management of the company to protect the interests of stakeholders. Determination of efficient investment decisions will provide more benefits for the company in the future. This will improve the welfare of the stakeholders.

There are findings that corporate governance mechanisms have a significant effect on investment efficiency [12, 13, 14, 35]. The implementation of corporate governance can provide improvements to more effective company supervision and control practices to assist in more efficient decision-making.

**H3: Corporate governance has a positive and significant impact on investment efficiency**

Earnings quality provides an overview to the decision-makers regarding the investmentto be taken. Earnings can be information in influencing decision-making by interested parties significantly [36]. Increasingly earnings quality will reflect investment opportunities that can be more efficient in increasing the welfare of the company as well as shareholders and other stakeholders. Improving the quality of earnings will assist management in making efficient investments for the company. Managers present financial reports without any elements of opportunistic actions that harm the company. This impact will affect the earnings generated bythe company in the quality of the financial statements.

The implementation of corporate governance will direct and increase the supervision of managers in presenting increasingly quality earnings by minimizing the possibility of earnings management actions by managers. This will reflect the increasing quality of earnings through better corporate governance to provide more reliable and relevant information in determining investment decision-making according to company needs by taking into account the company's growth as presented in earnings quality. In addition, it can also provide informationon taking effective action to increase capital when the company is experiencing a shortage of capital when it wants to make investments that have long-term profitable projects. Thus, the investment made by the company can be more efficient according to the needs of the company.

The presentation of increasingly quality earnings can be obtained from the implementation of corporate governance through actions to control and supervise the actionsof managers. This will assist the company in making appropriate and efficient decisions, especially investment decisions. Looking at the growth of the company presented in terms of earnings quality will help decision makers to determine investments that are under the company's conditions to make it more efficient. In addition, it can also provide direction in determining the appropriate addition of capital when the company experiences a shortage of capital when it wants to take investment opportunities that provide long-term benefits.

**H4: Earnings quality mediates the effect of corporate governance on investment efficiency**

## 3 Research Design

The population in this study are all manufacturing sector companies listed on the Indonesia Stock Exchange (IDX) during the 2018-2020 period. This study used a sample that was selected based on the purposive sampling method. The type of data used in this study is documentary data, namely annual reports published by public companies listed on the IDX during the 2018-2020 period and the company's official website. The data source used in this research is secondary data obtained from the Indonesian Stock Exchange website (www.idx.co.id).

Corporate governance is measured by one measure that is recognized globally by policymakers, investors and other stakeholders with the principles of corporate governance by the OECD (The Organization for Economic Co-operation and Development) as the main benchmark in the scorecard [37]. The scorecard is the ASEAN Corporate Governance Scorecard (ACGS). Earnings quality proxied by discretionary accruals will be calculated usingthe modified Jones model because this model is seen as better than other models [38]. This study uses a model of measuring investment efficiency as a function of growth opportunities whose residual value will be used as the value of investment efficiency [19].

## 4 Results and Discussion

### 4.1 Results

Descriptive statistics consisting of the mean, maximum, minimum, and standard deviation of the corporate governance, earnings quality, and investment efficiency variables are presented in table 1.

**Table 1.** Descriptive Statistics

| Variable | Observation | *Minimum* | *Maximum* | *Mean* | *Std. Deviation* |
|---|---|---|---|---|---|
| *Corporate Governance* (CG) | 95 | 46,0949 | 88,7138 | 68,1393 | 9,1201 |
| Earnings Quality (EQ) | 95 | 0,0035 | 0,2816 | 0,0462 | 0,0393 |
| Investment Efficiency (EI) | 95 | 0,0011 | 0,0799 | 0,0290 | 0,0162 |

The regression model in path analysis is used in hypothesis testing to predict the relationship between the independent variables and the dependent variable. The results of the analysis are presented in table 2.

**Table 2.** Path Analysis Results

| Model | *Unstandardized Coefficient* | | *Standardized Coefficient Beta* | Sig. |
|---|---|---|---|---|
| | *B* | *Std. Error* | | |
| Corporate Governance → Earnings Quality | ,001442 | ,000421 | ,335 | ,001 |
| Corporate Governance → Investment Efficiency | ,000224 | ,000183 | ,126 | ,225 |
| Earnings Quality → Investment Efficiency | ,122054 | ,042554 | ,296 | ,005 |

The Sobel test in this study is useful for testing the strength of the indirect influence of corporate governance on investment efficiency through earnings quality. The results of the Sobel test in this study can be seen in table 3.

**Table 3.** Path Analysis Results

| Model | B | *Std. Error* | *p-value of Sobel Test (one-tailed probability)* |
|---|---|---|---|
| Corporate Governance → Earnings Quality → Investment Efficiency | ,00144; ,12205 | ,00042; ,04255 | ,01390 |

## 4.2 Discussion

**The effect of corporate governance on earnings quality**

The implementation of corporate governance with a high ACGS score indicates that earnings quality are generated by the company through the form of company management and control and supervision of management behavior to minimize opportunistic actions taken. healthier corporate practices are on the rise. This will prevent the company from deviating from management actions [39]. Improved monitoring and control practices will minimize the opportunity for management to take opportunistic actions that are detrimental to the company. The implementation of better corporate governance will provide added value to the company and increase the value of the company in improving its financial performance and reduce the risk of possible management taking actions for personal gain so that it will generate increasingly earnings quality.

This research is in line with agency theory which states that corporate governancefunctions as a mechanism capable of building better internal relations to minimize agency conflicts between principals and agents. This relationship will bring harmony of thought between the principal and agent in realizing company goals. The results of this study are consistent and in line with previous studies which found that corporate governance has a positive and significant effect on earnings quality [26, 28, 29].

**The effect of earnings quality on investment efficiency**

Earnings quality indicators in the form of discretionary accruals describe how the company presents its earnings under the company's fundamental conditions which will indicate sustainable activity, adequate returns, and lack of manipulation [34]. Discretionary accruals have a strong relationship with management's actions in presenting more relevant earnings so better management actions will improve the presentation of increasingly quality earnings. This is useful for companies in determining and planning efficient investment actions in the future along with increasing growth. Thus, the better quality of earnings will increase investment efficiency in the form of efficient investment actions by adjusting the totalnew investment made and the growth experienced by the company.

This research is in line with agency theory which states that earnings quality is useful in providing relevant information for making the right decision for the agent in fulfilling the principal's wishes. Decision-making, especially in terms of company investment, can adjustthe company's growth to the total investment made by the company. Efficient investment decisions will be realized if the company can minimize the act of earnings deviation which causes the accrual earnings quality to be lower. The results of this study are consistent and in line with previous studies which found that earnings quality has a positive and significant effect on investment efficiency [18, 20, 33].

**The influence of corporate governance on investment efficiency**

Corporate governance should be able to become a policy to realize investment efficiency which shows the quality of a good company. However, corporate governance cannot be a strong system for the efficiency of corporate investment. This is caused by an efficientcompany investment that is not enough to obtain more relevant accounting information only from corporate governance regarding the implementation of monitoring and control measures. Managers consider corporate governance practices only as a form of compliance with regulations or provisions, not as a system required by the company to improve performance [40]. In addition, internal problems such as the low level of understanding from leaders and employees regarding the principles of good corporate governance, the absence of a corporate culture that encourages the realization of good corporate governance principles, and theineffectiveness of the company's internal control system [41]. Managers are not capableenough to take efficient investment actions so other indicators are needed that can help overcome this.

The results of this study are in line with previous research which found that corporate governance has no significant effect on investment efficiency [12]. Corporate governance is less effective in overcoming managers in the majority of companies controlled by the government which prioritizes interests outside the company, causing investment inefficiencies.

**The role of earnings quality mediation in mediating the effect of corporate governance on investment efficiency**

Agency theory states that the agency relationship between principal and agent affects the company in carrying out its operations. One method that can be applied by companies to minimize agency conflicts such as decision-making, achieving company goals, and presenting information that is more relevant to increasing earnings quality is by implementing corporate governance. Corporate governance can provide direction to the company in increasing its effectiveness of the company because it can realize the implementation of better supervision and control measures. Thus, the behavior of managers with integrity will arise to help present earnings that provide relevant and sufficient information so that they will reflect earnings that are under company conditions in a quality manner.

The higher the quality of earnings in the form of high accrual quality will reflect the lower the value of earnings deviations so that it can produce a smaller number of discretionaryaccruals. This will be an indicator for the company that managers use the available information effectively and efficiently so that it will cause the company's earnings quality to increase. Increasing the quality of earnings will further become a predictor that provides quality information to reduce the cost of capital which is an important element in making investment decisions. This will create decision-making in the form of efficient investment actions that will increase the company's growth faster. Efficient investment decisions will helpcompanies avoid conditions of investment inefficiency along with an adequate level of sales ininvestment planning with long-term benefits.

In addition, efficient investment decisions with earnings quality considerations for appropriate investment planning will provide stakeholders with the awareness that the company has implemented more effective and efficient corporate governance. This can beseen in the company's policies through the improvement of healthier company practices andthe implementation of supervisory actions in directing the actions of managers to improve adequate relations between principals and agents for the achievement of company goals. Thus,earnings quality plays a role in mediating the effect of corporate governance on investment efficiency.

## 5 Conclusions

Companies that have better corporate governance practices tend to have increased earnings quality. This is caused by sound company practices and supervisory actions that are under the principles of corporate governance will increase the behavior of managers with moreintegrity for operational sustainability. Companies that have high earnings quality tend to have increased investment efficiency. This is because managers have utilized relevant accounting information effectively in carrying out efficient investment planning with long-term benefits. Corporate governance does not have a strong enough influence in increasing investment efficiency. This is because managers are not sufficient to obtain accounting information that is more relevant only to the implementation of better corporate governance. After all, there areno more specific indicators as media in obtaining adequate information to assist agents in carrying out the company's operational activities. Investment decision-making will tend to be less efficient and not all company managers have carried out their duties effectively. Earnings quality can increase managers' confidence in the effectiveness of corporate governance in terms of faster company productivity and growth to produce relevant accounting information in the context of making efficient investment decisions.

The limitation of this research lies in the relatively short research period and onlyexamines one type of industry, namely manufacturing companies. In addition, the measurement of investment efficiency uses the residual value of the entire investment without distinguishing between under-investment or over investment conditions. Future research should extend the research period so that the number of samples tested becomes larger for maximum results and can examine other industries that are rarely researched for comparison with this study. Future research can consider measuring investment efficiency by using more specific measurement tools related to company conditions such as overinvestment and underinvestment.

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