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Earnings Quality as a Mediator in the Relationship between Fraud Diamond and Firm Value: Evidence from Indonesia

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ABSTRACT

This study investigates the mediating role of earnings quality in the relationship between the Fraud Diamond framework and firm value in Indonesian manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2020 to 2024. Using agency and stakeholder theories as the theoretical foundation, four fraud risk factors, financial target, ineffective monitoring, change in auditor, and change in director are examined for their direct and indirect effects on earnings quality and firm value. Data from 120 firm-year observations were analyzed using descriptive statistics, classical assumption tests, regression analysis, path analysis, and the Sobel test. The findings indicate that financial targets and ineffective monitoring negatively affect earnings quality, while changes in auditor and changes in director show no significant impact. Furthermore, earnings quality positively influences firm value and mediates the effect of financial target and ineffective monitoring on firm value. These results provide insights for regulators, investors, and corporate management on the importance of strengthening governance mechanisms to enhance earnings quality and safeguard firm value.

KEY WORDS: Fraud Diamond, Earnings Quality, Firm Value, Corporate Governance, Indonesia Stock Exchange

1. Introduction

Financial reporting plays a fundamental role in ensuring transparency, accountability, and efficiency in capital markets. According to PSAK 1, the primary objective of financial statements is to provide information on the financial position, performance, and cash flows of an entity that is useful for decision-making by investors, creditors, and other stakeholders. Earnings, in particular, are one of the most widely used indicators in assessing managerial performance, evaluating operational success, and predicting future cash flows. Investors and creditors rely heavily on earnings information not only to estimate a firm's earnings power but also to assess the overall sustainability of its financial health.

However, the reliability of earnings has been a longstanding concern. The concept of earnings quality emerges as a critical factor that distinguishes between sustainable earnings that reflect true economic performance and manipulated earnings that distort financial reality. High-quality earnings provide accurate signals of a company's operations, facilitate better investment decisions, and ultimately enhance firm value. Conversely, low-quality earnings resulting from earnings management or fraudulent reporting can mislead

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stakeholders and lead to significant losses in market trust and firm value (Peterson, K Ozili, 2017).

In the Indonesian context, corporate scandals and financial irregularities underscore the urgency of addressing earnings quality and fraud risk. For instance, in 2024, the Supreme Audit Board (BPK) revealed manipulations in the financial statements of PT Indofarma, which resulted in potential state losses exceeding IDR 371 billion. Similar irregularities were also identified in credit facilities involving PT Linkadata Citra Mandiri and state-owned banks. Such cases highlight the vulnerabilities in financial reporting systems and demonstrate how fraudulent behavior not only erodes investor confidence but also reduces firm value in the capital market.

Fraudulent behavior is often explained using fraud theory. Initially, the fraud triangle theory identifies three factors that drive fraudulent behavior: pressure, opportunity, and rationalization. (Abernetiiy & U.Stoelwinder, 1995; Berman et al., 2016; Levy, 2004) Later expanded this model into the fraud diamond theory, which adds capability as a fourth factor. Together, these four elements, financial pressure, weak monitoring, rationalization, and managerial capability, provide a comprehensive framework for understanding the drivers of fraudulent financial reporting (Prakosa et al., 2022; Sarwoko & Agoes, 2014; Watts, 2003).

Despite its relevance, empirical evidence linking the fraud diamond framework to firm value remains fragmented. Prior studies tend to focus on the direct relationship between fraud indicators and financial statement fraud, or between earnings quality and firm value, without fully integrating these concepts into a mediation framework. In practice, earnings quality can serve as a critical channel through which fraud risk factors influence firm value. For example, unrealistic financial targets may pressure managers into earnings management, reducing earnings quality and ultimately decreasing firm value. Similarly, ineffective monitoring may open opportunities for manipulation, while auditor or director changes can affect the governance environment in ways that shape the reliability of reported earnings (Dyck et al., 2010; Rao et al., 2025).

From a theoretical standpoint, this study is grounded in agency theory and stakeholder theory. Agency theory emphasizes the conflict of interest between principals (shareholders) and agents (managers), where information asymmetry may lead to opportunistic managerial behavior. Fraudulent financial reporting can be seen as an outcome of this conflict, especially when earnings quality is compromised to meet short-term objectives. Stakeholder theory broadens this perspective by recognizing that the firm's survival and growth depend on meeting the expectations of multiple stakeholders, including investors, regulators, creditors, and the public. Thus, earnings quality is not only an accounting construct but also a strategic signal that affects firm value through stakeholder perceptions.

Given the persistence of fraud cases in Indonesia and the need to strengthen market trust, this study addresses an important gap by examining the mediating role of earnings quality in the relationship between the fraud diamond elements and firm value (Bakre, 2007; Schrand & Zechman, 2012a, 2012b). Using data from manufacturing firms listed on the Indonesia Stock Exchange (IDX) between 2020 and 2024, this study aims to provide empirical evidence on how fraud risk factors shape firm value directly and indirectly through earnings quality.

The contributions of this study are threefold. First, it enriches the accounting literature by integrating the fraud diamond framework with earnings quality and firm value, offering a comprehensive model of financial reporting outcomes. Second, it provides practical implications for corporate managers to strengthen monitoring mechanisms and set realistic financial targets in order to improve earnings quality. Third, it informs regulators and investors about the importance of earnings quality as a signal of firm performance, thereby guiding policy and investment decisions.

2. Literature Review and Hypothesis Development

2.1 Fraud Diamond Theory

Fraud in financial reporting is a complex phenomenon influenced by multiple behavioral, organizational, and structural factors. The fraud diamond theory offers a framework to understand why fraud occurs by incorporating four dimensions: pressure, opportunity, rationalization, and capability. Pressure arises when companies or managers face financial expectations that are difficult to achieve. These may include ambitious profitability goals, high return on assets, or expectations from shareholders to sustain growth. (Ak et al., 2013; Gordon et al., 2013; Kin Lo, 2008; Lo, 2008) When such targets are unrealistic, managers may feel compelled to manipulate financial results to avoid disappointing stakeholders. Opportunity reflects weaknesses in corporate governance and monitoring mechanisms. When boards of commissioners, audit committees, or external oversight mechanisms fail to function effectively, managers are provided with the space to alter reports without detection.

Weak internal controls or passive supervision are particularly critical in creating this opportunity. Rationalization refers to the mindset that justifies unethical actions. Managers who manipulate financial statements often believe that they are protecting the company's reputation, securing temporary stability, or simply doing what others in the industry are already doing. Such rationalizations reduce the psychological barrier to committing fraud. Capability emphasizes that fraud can only be carried out when individuals have the authority, expertise, and confidence to manipulate reporting systems. Changes in directors or individuals with strong influence at the top management level can increase the likelihood of fraud because these leaders are in positions to override controls (Bharati et al., 2016; Bhatia, 2016; Brown & Jones, 2015; Ferry et al., 2017).

Together, these four dimensions create conditions where financial reporting fraud becomes possible. Importantly, the fraud diamond theory highlights that not all managers under pressure will commit fraud; the interaction of all four elements increases the likelihood of misconduct.

2.2 Earnings Quality

Earnings quality is the degree to which reported earnings reflect the true economic performance of a company. High-quality earnings are sustainable, free from excessive discretionary adjustments, and closely aligned with cash flow performance. Such earnings provide reliable information for predicting future performance and for evaluating the long-term viability of the business. (Dechow, 2006; Development et al., 2016; Litterman, 2003)

Conversely, low-quality earnings occur when reported results are significantly influenced by accounting choices rather than actual performance. This often takes the form of earnings management, where management accelerates or defers revenue, manipulates expenses, or alters provisions to meet certain targets. While these adjustments may improve short-term appearance, they reduce the ability of earnings to serve as a credible performance indicator (Asri, 2017).

Earnings quality is therefore not only an accounting construct but also

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a governance issue. Strong governance mechanisms, independent oversight, and effective monitoring are expected to limit opportunistic earnings management, while weak structures can allow managers to pursue private benefits at the expense of stakeholders.

2.3 Firm Value

Firm value reflects the market's perception of a company's worth. It captures both tangible financial results and intangible factors such as credibility, growth potential, and investor trust. A company with high firm value typically signals that it is performing well, managing its resources effectively, and generating strong prospects. Market indicators such as Tobin's Q and price-to-book ratio are widely used to measure firm value.

Firm value is sensitive to information quality. When investors perceive financial statements as credible, confidence in the company increases, leading to higher demand for shares and stronger valuations(Ali & Asri, 2019). Conversely, when earnings are perceived as unreliable or manipulated, investor trust erodes, often leading to declining stock prices. Fraudulent reporting cases frequently result in sharp declines in firm value because markets adjust rapidly to correct misperceptions once manipulation is revealed.

2.4 Linking Fraud Diamond, Earnings Quality, and Firm Value

The relationship between fraud risk factors, earnings quality, and firm value can be explained in an integrated framework. Fraud diamond factors create incentives and conditions for earnings manipulation. When manipulation occurs, earnings quality deteriorates because reported results no longer reflect true performance. Lower earnings quality weakens investor confidence and reduces firm value. Financial targets as a form of pressure often push management to meet benchmarks regardless of economic reality. If managers respond by engaging in earnings management, earnings quality is reduced, and firm value eventually declines once manipulation is detected. Ineffective monitoring provides managers with opportunities to act opportunistically without fear of detection (Measurement, n.d.; Penman & Zhang, 2002; Richardson et al., 2010).

Weak oversight leads to more aggressive accounting choices, further lowering earnings quality and diminishing trust among investors. A change in auditor may affect the governance environment by reducing continuity in audit quality. In some cases, a new auditor may be less familiar with company operations, creating room for managers to manipulate results. This may indirectly influence earnings quality and, by extension, firm value. Change in director reflects shifts in leadership and strategic direction. While new leadership may strengthen governance, it can also create opportunities for manipulation, particularly when new directors seek to present better short-term results to establish credibility. Such changes can alter the company's approach to earnings reporting and affect market perceptions. (Basilico, 2014; Bozhkov et al., 2020; Dechow et al., n.d.)

In this framework, earnings quality serves as a mediator. The fraud diamond factors do not always reduce firm value directly. Instead, they exert their influence through earnings quality. Investors often respond not to the fraud risk factors themselves but to the credibility of reported performance. High-quality earnings mitigate the negative impact of fraud risk, while low-quality earnings amplify it.

2.5 Hypothesis Development

From the discussion above, the following hypotheses are formulated:

H1: Financial target hurts earnings quality.

H2: Ineffective monitoring hurts earnings quality.

H3: A Change in auditor hurts earnings quality.

H4: A Change in the director hurts earnings quality.

H5: Financial target hurts firm value.

H6: Ineffective monitoring hurts firm value.

H7: A Change in auditor hurts firm value.

H8: A Change in directors hurts firm value.

H9: Earnings quality has a positive effect on firm value and mediates the relationship between fraud diamond elements and firm value.

3. Methodology

3.1 Research Design

This study adopts a quantitative, explanatory research design. The explanatory approach is appropriate because it aims to test causal relationships between the Fraud Diamond elements, earnings quality, and firm value. In particular, the study examines both the direct effects of financial target, ineffective monitoring, change in auditor, and change in director on earnings quality and firm value, as well as the indirect effects mediated by earnings quality. The research design also incorporates statistical modeling in the form of regression and path analysis, enabling simultaneous testing of direct, indirect, and total effects.

3.2 Population and Sample

The population of this study consists of manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the period 2020–2024. The manufacturing sector was selected because it is one of the largest and most influential industries in Indonesia's economy, and previous studies suggest that manufacturing firms are particularly vulnerable to earnings management and fraudulent reporting.

The sampling method used is purposive sampling with the following criteria:

1. Companies must be listed continuously on the IDX during the observation period 2020–2024.
2. Companies must publish annual financial statements audited by independent auditors.
3. Companies must disclose complete data required for the measurement of variables, including earnings, total assets, board composition, auditor information, and market values.
4. Companies that experienced delisting, suspension, or incomplete reporting during the observation period are excluded.

Applying these criteria, a total of 120 firm-year observations were obtained, representing approximately 30 companies over the 5 years.

3.3 Data Sources

The study relies on secondary data obtained from:

1. Annual financial reports published by manufacturing companies on the IDX official website.
2. IDX Fact Book and company profiles for cross-verification of firm value and governance variables.
3. Audit reports for information on auditor changes and audit opinions.
4. Corporate announcements for data on director changes.

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5. All financial data are reported in Indonesian Rupiah (IDR) and standardized for comparability across firms and years.

3.4 Data Collection Method

Data collection was carried out through documentation of company reports, supported by manual cross-checking of announcements and regulatory filings. The collected data were tabulated into a panel dataset, ensuring consistency in variable measurement across firms and time.

3.5 Operational Definition and Measurement of Variables

Independent Variables (Fraud Diamond Proxies):

1. Financial Target (Pressure): Measured by Return on Assets (ROA), calculated as net income divided by total assets. Higher ROA indicates stronger financial targets and greater pressure to maintain or increase performance.
2. Ineffective Monitoring (Opportunity): Proxied by the proportion of independent commissioners (BDOUT), measured as the number of independent commissioners divided by total board size. Lower proportions indicate weaker monitoring.
3. Change in Auditor (Rationalization): A dummy variable equal to 1 if the company changes its external auditor in a given year, and 0 otherwise.
4. Change in Director (Capability): A dummy variable equal to 1 if there is a change in the CEO or board of directors in a given year, and 0 otherwise.

Mediating Variable:

Earnings Quality: Measured using discretionary accruals estimated through the Modified Jones Model (Dechow et al., 1995). A higher level of discretionary accruals indicates lower earnings quality.

Dependent Variable:

Firm Value: Proxied by Tobin's Q, calculated as the ratio of the market value of equity plus book value of debt to total assets. Tobin's Q captures investors' perceptions of the firm's future growth potential.

3.6 Research Model

The research model can be expressed as:

1. Earnings Quality Equation (Model 1):

$EQ=\alpha 1+\beta 1FT+\beta 2IM+\beta 3CA+\beta 4CD+\epsilon$…………….(1)

2. Firm Value Equation (Model 2):

$FV=\alpha 2+\beta 5FT+\beta 6IM+\beta 7CA+\beta 8CD+\beta 9EQ+\epsilon$………..(2)

EQ = Earnings Quality;FV = Firm Value;FT = Financial Target;IM = Ineffective Monitoring; CA = Change in Auditor; CD = Change in Director

3.7 Hypothesis Testing

Hypotheses were tested using significance levels of 5% ($p < 0.05$). A hypothesis is accepted if the p-value of the coefficient is below 0.05 and rejected otherwise. Mediation is confirmed if the indirect effect (Fraud Diamond to Earnings Quality to Firm Value) is significant according to the Sobel test.

4. Results and Discussion

Table 1. Descriptive Statistics

Variable	Mean	Min	Max	Std. Dev.
Financial Target (ROA)	5.12	-2.30	14.25	3.45
Ineffective Monitoring	0.38	0.20	0.75	0.14
Change in Auditor	0.32	0.00	1.00	0.47
Change in Director	0.28	0.00	1.00	0.45
Earnings Quality	0.11	-0.25	0.43	0.09
Firm Value (Tobin's Q)	1.52	0.85	3.10	0.56

Table 2. Regression Results

Model 1: Earnings Quality as Dependent Variable

Variable	Coefficient	t-stat	Sig.
Financial Target	-0.142	-2.85	0.005
Ineffective Monitoring	-0.198	-3.12	0.002
Change in Auditor	-0.051	-1.21	0.228
Change in Director	-0.037	-0.88	0.379
$R^2 = 0.36$	Adj. $R^2 = 0.33$	F = 12.14	Sig. = 0.000

Model 2: Firm Value as Dependent Variable

Variable	Coefficient	t-stat	Sig.
Financial Target	-0.121	-2.44	0.016
Ineffective Monitoring	-0.102	-2.11	0.037
Change in Auditor	-0.025	-0.59	0.556
Change in Director	-0.033	-0.74	0.462
Earnings Quality	0.278	4.15	0.000
$R^2 = 0.41$	Adj. $R^2 = 0.38$	F = 15.27	Sig. = 0.000

Table 3. Sobel Test (Mediation Analysis)

Path	Z-value	Sig.	Mediation
Financial Target to EQ to FV	2.31	0.021	Partial
Ineffective Monitoring to EQ to FV	2.67	0.008	Partial
Change in Auditor to EQ to FV	0.91	0.364	None
Change in Director to EQ to FV	0.77	0.442	None

Discussion in the Context of Fraud Diamond

Financial Target (Pressure):

The findings confirm that financial targets, as a measure of managerial pressure, play a critical role in shaping earnings quality and firm value. When companies face ambitious targets, managers may experience pressure to meet benchmarks even when actual performance falls short. This pressure often translates into earnings manipulation, reducing earnings quality. In the long run, markets penalize firms that sacrifice earnings credibility, leading to a decline in firm value. This supports the fraud diamond perspective that

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pressure is a primary driver of fraudulent behavior in financial reporting.

Ineffective Monitoring (Opportunity):

The study also finds that ineffective monitoring significantly reduces earnings quality and firm value. Weak governance structures, such as a low proportion of independent commissioners, create opportunities for managers to manipulate earnings with little fear of detection. This aligns with the fraud diamond's second element, which emphasizes that opportunity is a necessary condition for fraud to occur. When boards and audit committees fail to provide effective oversight, the likelihood of financial misreporting increases, reducing investor trust and weakening firm value.

Change in Auditor (Rationalization):

Contrary to expectations, auditor changes did not significantly influence earnings quality or firm value. This suggests that the mere occurrence of an auditor change may not necessarily indicate a higher risk of fraud or manipulation. Managers may rationalize their actions regardless of whether the auditor changes, and investors may not perceive such changes as a strong signal of fraud risk. This result highlights that the fraud diamond element of rationalization may operate in more subtle ways that are not easily captured by auditor change alone.

Change in Director (Capability):

Similarly, changes in directors were not significantly associated with earnings quality or firm value. Although the fraud diamond emphasizes capability as a key factor in enabling fraud, this study suggests that director changes do not automatically translate into greater earnings manipulation. Governance mechanisms or market scrutiny may mitigate the potential risks associated with leadership transitions. Capability may still matter, but its impact might depend on other contextual factors such as the strength of internal controls or corporate culture.

Earnings Quality as Mediator:

The results strongly confirm that earnings quality acts as a mediator between fraud diamond elements and firm value. Financial targets and ineffective monitoring reduce earnings quality, which in turn reduces firm value. This underscores the importance of focusing not only on fraud risk factors themselves but also on how they affect the credibility of reported earnings. Earnings quality becomes the channel through which pressure and opportunity are transmitted into market perceptions of firm value.

5. Conclusion, Implications, Limitations, and Acknowledgments

5.1 Conclusion

This study set out to examine the mediating role of earnings quality in the relationship between the fraud diamond framework and firm value in manufacturing companies listed on the Indonesia Stock Exchange during 2020–2024. The findings provide several important insights.

First, two fraudulent diamond elements, financial target (pressure) and ineffective monitoring (opportunity), were found to significantly reduce earnings quality and firm value. These results confirm that pressure to meet ambitious financial goals and weaknesses in governance mechanisms create strong incentives and opportunities for earnings manipulation, undermining the reliability of financial reports.

Second, changes in auditors (rationalization) and directors (capability) did not significantly influence earnings quality or firm value. This suggests that while these factors are conceptually important within the fraud diamond framework, their observable impact in this setting may be limited or mitigated by other institutional and market mechanisms.

Third, earnings quality was shown to play a crucial mediating role. High-quality earnings strengthen the credibility of financial information and enhance firm value, while low-quality earnings erode investor confidence and reduce valuation. This confirms that earnings quality is the key channel through which fraud risk factors affect firm value.

Overall, the study underscores the importance of earnings quality as a bridge between fraud risk and firm value and highlights that pressure and opportunity are the most dominant fraud diamond elements influencing corporate outcomes in the Indonesian context.

5.2 Theoretical Implications

The findings extend the fraud diamond theory by empirically demonstrating that not all four elements are equally influential in practice. Pressure and opportunity appear to exert stronger observable effects than rationalization and capability. Moreover, by positioning earnings quality as a mediator, the study advances the theoretical understanding of how fraud risk factors translate into changes in firm value. This integration enriches the accounting and finance literature by linking fraud theory with financial reporting outcomes and market perceptions.

5.3 Managerial Implications

For corporate managers, the study highlights the risks associated with setting unrealistic financial targets that pressure employees and executives into manipulating earnings. Management should focus on establishing performance targets that are ambitious yet achievable, supported by sound operational strategies rather than cosmetic accounting adjustments. Strengthening the role of independent commissioners and audit committees is equally important to reduce opportunities for manipulation. Ultimately, fostering a culture of ethical reporting and accountability is central to sustaining firm value.

5.4 Regulatory and Policy Implications

For regulators, the findings emphasize the need to reinforce governance and monitoring frameworks in Indonesian capital markets. Strengthening disclosure requirements, enhancing the role of independent commissioners, and increasing the accountability of auditors can help reduce fraud risk. Regulatory bodies should also focus on ensuring that corporate targets and reporting practices align with sustainable performance rather than short-term market expectations.

5.5 Societal Implications

The reliability of financial reporting has direct consequences for society at large, particularly in economies where capital markets play an important role in mobilizing resources. Fraudulent financial reporting not only harms investors but also undermines trust in markets, reduces economic efficiency, and erodes confidence in institutions. By emphasizing earnings quality, this study highlights the broader societal value of transparent and credible corporate reporting.

5.6 Limitations and Suggestions for Future Research

This study has several limitations. First, the focus on manufacturing firms limits the generalizability of the findings to other industries, such as banking or services, where governance dynamics may differ. Second, the measurement of earnings quality was restricted to

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discretionary accruals using the modified Jones model, which may not capture all dimensions of reporting quality. Third, the study period (2020–2024) coincided with global economic disruptions, which may have influenced managerial behavior in unique ways.

Future research could expand the scope to include multiple sectors, apply alternative measures of earnings quality such as real earnings management or restatements, and extend the time horizon to examine long-term effects. Exploring the role of institutional ownership, audit quality, or corporate culture as moderating factors could also provide valuable new insights.

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