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The Moderating Role of Earnings Quality in the Nexus Between Financial Risk, Profitability, Investment Opportunity Set, and Foreign Ownership with Financial Reporting Integrity

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Abstract:
This study examines the influence of financial risk, profitability, investment opportunity set, and foreign ownership on financial reporting integrity, with earnings quality acting as a moderating variable, in Indonesian state-owned enterprises (SOEs). Using panel data from 21 SOEs listed on the Indonesia Stock Exchange from 2021 to 2024, the analysis was conducted through Partial Least Squares Structural Equation Modeling. The findings reveal that profitability significantly enhances financial reporting integrity, and this relationship is further strengthened when earnings quality is high. Meanwhile, financial risk, investment opportunity set, and foreign ownership do not show direct effects on reporting integrity. However, earnings quality weakens the influence of foreign ownership on reporting integrity and does not moderate the effects of the other variables. These results highlight the critical role of profitability and earnings quality in supporting the integrity of financial reporting within SOEs, and suggest that regulatory frameworks in these entities may mitigate risks that typically compromise reporting integrity in private firms.

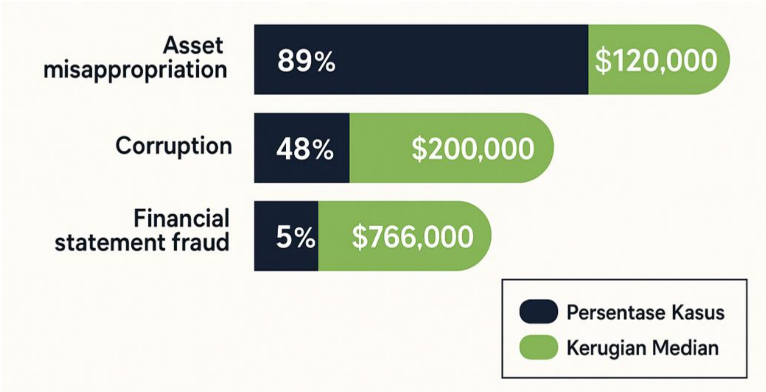
Keywords: Financial Reporting Integrity, Earnings Quality, Financial Risk, Profitability, Foreign Ownership, Investment Opportunity Set.

1. Introduction

In 2025, the global financial landscape has witnessed a surge in concerns over the credibility and transparency of corporate financial reporting, intensified by several high-profile scandals and a growing body of forensic audit evidence (1). Notably, the International Federation of Accountants (2) highlighted that despite increased regulatory oversight, manipulation in financial reporting remains a persistent issue, eroding investor trust and undermining market stability. The (3) ranked financial fraud, particularly through misreporting, among the top five non-cyber economic risks to global financial systems. A groundbreaking study by (4) (4)revealed that nearly 42% of detected corporate fraud cases between 2021–2023 involved deliberate misstatements in financial reports, a sharp rise from pre-pandemic levels. This trend has prompted calls for greater scrutiny of financial disclosures, especially in emerging markets where regulatory enforcement may lag. In Indonesia, recent disclosures by the Indonesian Financial Services Authority (OJK, 2025) and findings from the Association of Certified Fraud Examiners (5) further emphasize a troubling uptick in the manipulation of financial statements in Asia, particularly within State-Owned Enterprises (SOEs), reflecting systemic vulnerabilities and governance lapses. These developments underscore the urgent need to investigate and strengthen financial reporting integrity as a foundational pillar of corporate accountability and economic resilience.

In Indonesia, cases of financial report fraud have increased according to the KPK (6), aligned with the (7) findings that show negative trends toward financial reporting integrity. Inaccurate financial reports risk causing losses for parties relying on such information. Transparency and honesty in report preparation are key to reducing risks and maintaining market trust. In figure 1, based on the international (5) report, although only representing 5% of total cases, financial statement fraud causes the largest losses, amounting to $766,000. This is because this type of fraud is usually systematic and aims to display better performance than reality. The impact is not only financial but also reputational, legal, and systemic.

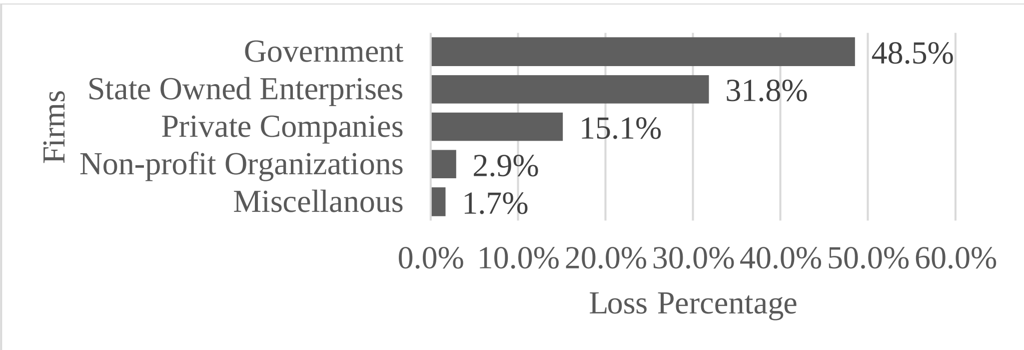
Fig 1. Percentage of Cases and Losses Incurred from Financial Reporting Integrity



Source: Data Analyzed from ACFE Report to The Nations, 2024)

Moreover, based on the (7) report in figure 2, government institutions and SOEs are the most disadvantaged entities, at 48.5% and 31.8% respectively. As many as 58.8% of cases occurred in SOEs (ACFE, 2016), indicating the high risk in this sector. Report manipulation often involves both internal and external parties, reflecting weak control and accountability (7).

Fig 2. Types of Institutions/Firms Most Disadvantaged by Fraud



Source: Data processed from Association of certified Fraud Examiners (2019)

Several major cases in Indonesia reinforce this issue. In 2018, PT Jiwasraya reported a profit of Rp2.4 trillion, but after an audit by PWC, it was corrected to Rp428 billion. The company subsequently failed to pay claims worth Rp802 billion (Kompas.id, 2020). Another case occurred at PT Garuda Indonesia in 2019, which recorded a profit of USD 809,850 from a previous loss of USD 216.5 million. However, two commissioners stated that the profit did not comply with PSAK because the revenue came from unrealized receivables (Hartomo, 2019; Kompas.id, 2019). The OJK imposed a fine of Rp100 million and required report revision. This case highlights the systemic impact of report manipulation. Based on these various cases, report manipulation, especially in SOEs and government institutions, is a serious issue with wide-ranging impacts. Therefore, this research focuses on financial reporting integrity as an effort to prevent fraud and maintain transparency. According to (9), financial reporting integrity is a principle that ensures reports reflect actual conditions without manipulation.

This research examines factors that influence financial reporting integrity. (10) and (11) identified five main variables: financial risk, profitability, investment opportunity set, foreign ownership, and earnings quality as a moderating variable. Financial risk is uncertainty in meeting financial obligations (12). High leverage drives managers to present reports that appear favorable to maintain funding, thus potentially reducing integrity. Agency theory (13) explains that this risk creates conflicts between managers and owners. Research by (14), (15), and (16) shows significant negative influence, although (17) and (18) found different results.

Profitability reflects a company's ability to generate profits (19). Good performance reduces manipulation pressure because there is no need to "polish" numbers (13). Research by (20), (21), and (22) shows positive influence, although (17) found no significant effect. Investment opportunity set (IOS) refers to future growth opportunities (23). Companies with high investment opportunity set tend to prepare accurate reports to attract investors and reduce capital costs. Research by (15) dan (24) supports this, although (25) found no significant relationship.

Foreign ownership brings expectations of better reporting. Foreign ownership adds pressure on management to maintain report quality (13). Research by (10), (26), and (27) supports this, while (28) emphasizes that its effectiveness depends on local context. Earnings quality serves as a moderator . High earnings quality can contain the negative effects of financial risk on financial reporting integrity (10), although (29) found no significant influence.

Earnings quality plays a moderating role in the relationship between financial risk and financial reporting integrity. High earnings quality acts as a safeguard against earnings manipulation when firms are exposed to elevated financial risk, helping maintain the reliability of reported figures (13). Studies by Ismail et al. (2024) supports this perspective, showing that strong earnings quality can mitigate the adverse effects of financial distress on reporting integrity. However, Rahman & Widodo (2022) found no significant moderating effect. In the case of profitability, earnings quality enhances the credibility of reported earnings, thereby reinforcing management's incentive to report transparently. When earnings quality is high, profit figures become more informative and trustworthy, contributing to improved financial reporting integrity (13). This argument is supported by (10) and (30), although Rahman & Widodo (2022) again reported an insignificant moderating influence.

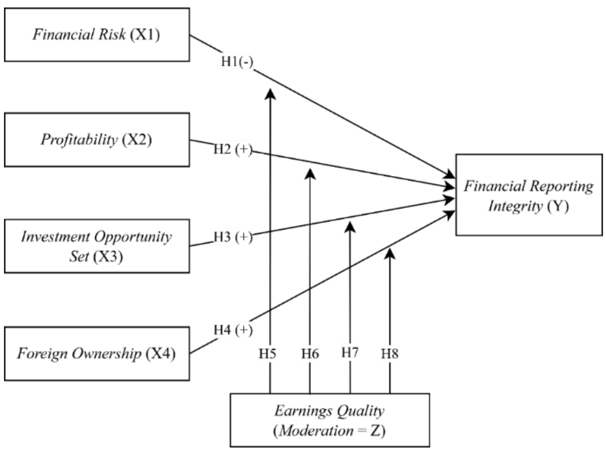
Earnings quality also moderates the relationship between investment opportunity set and financial reporting integrity. Firms with abundant future growth projects must establish investor trust, and high-quality earnings reporting becomes a key instrument for building that trust (13). Research by (31) confirms that earnings quality enhances the positive influence of growth opportunities on reporting integrity, while (32) found no significant moderating effect. Finally, in the context of foreign ownership, earnings quality strengthens the link with financial reporting integrity. Foreign ownership brings expectations of greater transparency and reliability in financial statements, and when earnings quality is high, it reassures foreign investors of the trustworthiness of the information presented (33). This view is supported by (10).

Taken together, these findings highlight the crucial role of earnings quality as a contingent governance mechanism that shapes how firms respond to internal financial drivers and external ownership pressures. In high-stakes environments like state-owned enterprises, where transparency and accountability are paramount, earnings quality serves not only as a technical accounting construct but also as a strategic tool to uphold the integrity of financial reporting under varying organizational conditions. Given this backdrop, this study aims to examine how financial risk, profitability, investment opportunity set, and foreign ownership influence financial reporting integrity in Indonesian SOEs, and how earnings quality moderates these relationships. The study is grounded in agency theory, which collectively suggest that firm-specific financial characteristics and governance structures interact to shape reporting behavior.

Based on this context, the following hypotheses are proposed:

- H1: Financial risk negatively influences financial reporting integrity.
- H2: Profitability positively influences financial reporting integrity.
- H3: Investment opportunity set positively influences financial reporting integrity.
- H4: Foreign ownership positively influences financial reporting integrity.
- H5: Earnings quality moderates the relationship between financial risk and financial reporting integrity.
- H6: Earnings quality moderates the relationship between profitability and financial reporting integrity.
- H7: Earnings quality moderates the relationship between investment opportunity set and financial reporting integrity.
- H8: Earnings quality moderates the relationship between foreign ownership and financial reporting integrity.

Fig 3. Conceptual Framework



Source: Data processed by researchers (2025)

2. Literature Review

2.1 Agency Theory

Agency theory, introduced by (13), explains the conflict of interest between principals (owners) and agents (managers) arising from delegated authority. While owners aim for long-term value maximization, managers may pursue personal goals such as job security or compensation. Agency costs monitoring expenses, incentive structures, and residual losses are incurred to align agent behavior with owner interests (34). According to (35), the theory serves both to guide decision-making (belief revision role) and performance evaluation. These rely on accurate and transparent reporting. Agency theory assumes that individuals act with self-interest, bounded rationality, and risk aversion, which together contribute to information asymmetry and the need for mechanisms ensuring accountability (23).

2.2 Financial Reporting Integrity

Financial reporting integrity refers to the extent to which financial statements truthfully represent a firm's actual financial condition. It involves transparency, accuracy, and resistance to earnings manipulation (Scott, 2003). Overstated earnings often used to meet external expectations—are a common distortion. Conservative accounting, which prioritizes early recognition of losses over gains, helps mitigate such manipulation (Givoly & Hayn, 2000). Measures like CONACC, Market-to-Book Ratio, and Earnings-to-Free-Cash-Flow Ratio assess the degree of integrity in reported financial data. A smaller gap between net income and operating cash flow also indicates higher reporting reliability (Higgins et al., 2023).

2.3 Earnings Quality

Earnings quality reflects the extent to which a company's reported earnings represent its actual economic performance (Dechow et al., 1995). It captures the sustainability and reliability of earnings, helping to distinguish between recurring income and results influenced by accounting choices. This study uses the Quality of Earnings (QoE) ratio, calculated by dividing Operating Cash Flow by Net Income. A high QoE indicates that net income is strongly backed by cash flow, signaling consistent and credible reporting. In contrast, a low QoE may imply that earnings are driven more by accruals than actual operations, raising concerns over possible earnings manipulation (Brigham & Houston, 2019).

2.4 Financial Risk

Financial risk refers to a company's exposure to potential financial distress due to its capital structure, particularly the extent of debt usage (Tracy, 2012). This study uses the Debt to Asset Ratio (DAR) to measure financial risk, calculated as total debt divided by total assets (Yuniningsih, 2018). A higher DAR indicates greater dependence on external financing, which increases the firm's obligation to meet interest and principal payments (Wahlen et al., 2018). When leverage is high, companies are more vulnerable to market fluctuations, liquidity issues, and pressure to maintain positive earnings (Yuniningsih et al., 2019). Companies with high financial leverage face more pressure in maintaining cash flow stability, making DAR a suitable proxy for financial risk.

2.5 Profitability

Profitability refers to a firm's ability to generate profit from its operations relative to its resources. It serves as a key indicator of financial performance and operational efficiency (Brigham & Houston, 2019). In this study, profitability is measured using Return on Assets (ROA), which compares net income to total assets. A high ROA indicates that the company is efficiently utilizing its assets to generate earnings (Yuniningsih et al., 2018). Profitability is a widely used metric for evaluating a firm's success, as it reflects the outcomes of management decisions and resource allocation (Pristi et al., 2022; Ramadhan & Takarini, 2022).

The Investment Opportunity Set (IOS) represents the range of productive projects available to a company that are expected to drive future growth (Myers, 1977). It indicates the firm's growth prospects and capacity to invest in value-creating activities (Ayem & Lori, 2020). This study uses the market value of equity to book value of assets ratio as a proxy, which reflects the market's expectations regarding a company's future investment potential (Kallapur & Trombley, 2001). A high IOS suggests that the market views the firm as having numerous profitable opportunities and strong potential for expansion (Putra & Hartono, 2021; Tinenti & Nugrahanti, 2023).

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2.7 Foreign Ownership

Foreign ownership refers to the proportion of a company's shares held by non-resident investors or entities (Ross et al., 2012). This includes individuals, foreign corporations, or institutions investing in domestic firms. In this study, foreign ownership is measured as the percentage of shares owned by foreign parties relative to total outstanding shares (36). According to Indonesian Law No. 25/2007, foreign investors may include individuals, legal entities, or foreign governments operating within Indonesia. The presence of foreign ownership typically brings demands for better governance, improved transparency, and accountability in firm operations (19).

3. Research Method

This research uses a quantitative approach with the Structural Equation Modeling–Partial Least Squares (SEM-PLS) method to test the influence of financial risk, profitability, investment opportunity set, and foreign ownership on financial reporting integrity, as well as the moderating role of earnings quality in these relationships. The sample consists of 21 SOE companies listed on the Indonesia Stock Exchange (IDX) during the 2021–2024 period, selected purposively. Secondary data was obtained from company financial statements and annual reports available on the official IDX website and respective company websites. Analysis was conducted using SEM-PLS with SmartPLS version 3.29, with model evaluation including validity, reliability, and hypothesis testing including the moderating effects of earnings quality (Hair et al., 2019). The following table summarizes all the variables used in the research, the operational definition, and the measurement method:

Variable	Type	Indicator / Measurement Formula	Source(s)
Financial Reporting Integrity	Dependent (Y)	CONACC = (NIO + DEP - CFO) -1 / Total Assets	Givoly & Hayn (2000) (37)
Financial Risk	Independent (X1)	Debt to Asset Ratio = Total Debt / Total Assets	Yuniningsih (2018) (38)
Profitability	Independent (X2)	ROA = Net Income / Total Assets	Pristi et al. (2022); Ramadhan & Takarini (2022) (39); (40)
Growth Opportunities	Independent (X3)	IOS = Market Value of Equity / Book Value of Assets	Kallapur & Trombley (2001) (41)
Foreign Ownership	Independent (X4)	FO = Foreign-Owned Shares / Total Outstanding Shares	Hutagaol-Martowidjojo et al. (2024); Brigham & Houston (2019)
Earnings Quality	Moderating (Z)	EQ = Operating Cash Flow / Net Income	Dechow et al. (1995); Brigham & Houston (2019) (33)

Source: Data processed by researchers (2025)

4. Result

Descriptive statistics analysis was carried out to provide an overview of the statistical characteristics of each variable used in this study. The following table shows the minimum, maximum, average, and standard deviation values of each variable:

Table 2. Descriptive Statistics Analysis

Construct	*Mean*	*Min*	*Max*	*Standard Deviation*
Financial Risk	0.634	0.233	0.881	0.195
Profitability	0.031	-0.181	0.282	0.060
Investment Opportunity Set	0.378	0.034	2.554	0.402
Foreign Ownership	0.149	0.001	0.781	0.180
Earnings Quality	2.336	-12.859	36.342	5.527
Financial Reporting Integrity	0.011	-0.113	0.241	0.072

Source: Data processed

Model testing was conducted in two stages: outer model and inner model evaluation. In the outer model stage, all indicators showed loading factor values > 0.7 and AVE values > 0.5, indicating that convergent validity was fulfilled. Additionally, composite reliability and Cronbach's alpha values from all constructs > 0.7, so constructs were declared reliable. Thus, indicators have represented their constructs well. Furthermore, inner model testing showed that the R^2 value for financial reporting integrity was 0.726, meaning that 72.6% of the variability in financial reporting integrity can be explained by the variables financial risk, profitability, investment opportunity set, foreign ownership, and the moderating effects of earnings quality. The Q^2 value was also positive, indicating that the model has predictive relevance.

Table 3. Original Sample and P-Value Results

	Original Sample (O)	T Statistics (|O/STDEV|)	P Values
Earnings Quality -> Financial Reporting Integrity	2.250	2.938	0.003
FO*EQ -> Financial Reporting Integrity	-0.518	2.231	**0.026**
FR*EQ -> Financial Reporting Integrity	0.004	0.027	0.979
Financial Risk -> Financial Reporting Integrity	0.043	0.497	0.619
Foreign Ownership -> Financial Reporting Integrity	-0.141	1.540	0.124
IOS*EQ -> Financial Reporting Integrity	-0.180	0.650	0.516
Investment Opportunity Set -> Financial Reporting Integrity	-0.201	1.136	0.257
P*EQ -> Financial Reporting Integrity	5.097	3.998	**0.000**
Profitability -> Financial Reporting Integrity	1.323	2.338	**0.020**

Source: Data processed using SmartPLS by Researchers (2025)

Based on the results of data processing with SmartPLS, it was found that financial risk does not significantly influence financial reporting integrity ($\beta = 0.043$; $p = 0.619$), so the first hypothesis is rejected. This means that increased financial risk does not necessarily directly impact reporting integrity. Conversely, profitability shows a significant positive influence ($\beta = 1.323$; $p = 0.020$), supporting the second hypothesis that companies with high profitability tend to maintain their reporting integrity. Testing of investment opportunity set resulted in a negative but non-significant relationship ($\beta = -0.201$; $p = 0.257$), so the third hypothesis is rejected. Similar findings were also found for foreign ownership ($\beta = -0.141$; $p = 0.124$), which did not show significant influence on report integrity, causing the fourth hypothesis to be unproven.

Regarding moderation aspects, the interaction financial risk × earnings quality was not significant ($\beta = 0.004$; $p = 0.979$), so the fifth hypothesis is rejected. However, the interaction profitability × earnings quality was significant and strengthened the relationship ($\beta = 5.097$; $p = 0.000$), supporting the sixth hypothesis. Conversely, the moderation of earnings quality on the relationship between investment opportunity set and financial reporting integrity was not significant ($\beta = -0.180$; $p = 0.516$), so the seventh hypothesis is rejected.

Interestingly, the interaction foreign ownership × earnings quality was significant but negative ($\beta = -0.518$; $p = 0.026$), indicating that earnings quality actually weakens this relationship, so the eighth hypothesis is rejected.

5. Discussions

This study finds that financial risk has little influence on how organizations maintain the integrity of their financial reporting. Despite agency theory suggesting that high financial risk could pressure management into presenting overly optimistic or misleading reports (Jensen & Meckling, 1976), this dynamic appears less pronounced in the sample companies. Risk exposure remained relatively stable, and variations in financial reporting integrity did not align with those risk levels. This may be attributed to the structured debt profiles in state-owned enterprises (SOEs), where financing often comes with regulatory oversight and strict compliance obligations. In such environments, financial risk does not emerge as a dominant factor shaping reporting behavior. These results reinforce earlier conclusions by Greenwood and Tao (2020), yet differ from the findings of Suzan and Iqbal (2024), who emphasize the deteriorating effect of leverage on report reliability.

Profitability, on the other hand, plays a contributing role in promoting financial reporting integrity. Companies with consistently positive financial performance tend to maintain or improve their reporting transparency. This suggests that when operational results are favorable, management has fewer incentives to engage in earnings manipulation. The internal confidence generated from strong profit margins appears to reduce the need for information concealment. From an agency perspective, this reflects a healthy alignment between managerial interests and those of external stakeholders (Jensen & Meckling, 1976). The finding supports insights from Safitri et al. (2023), Ibrahim et al. (2023), and Kumar and Singh (2024), although it contrasts with Widodo and Priyadi (2022), who observed inconsistent reporting practices despite high profitability.

The availability of investment opportunities does not appear to drive improvements in reporting quality. Despite theoretical expectations that growth-oriented firms would use transparent disclosures to signal potential to investors (Jensen & Meckling, 1976), this was not observed among the sampled SOEs. Even when investment prospects declined, companies did not respond with greater transparency in their reports. This could reflect the unique characteristics of SOEs, where strategic direction is influenced more by government priorities than by market performance. These results are consistent with Rahman and Abdullah (2022), who argue that weak governance mechanisms can override market incentives. However, they contrast with Pratiwi and Nofryanti (2021) and Chang and Wu (2024), who view investment potential as a driver of disclosure quality.

Foreign ownership does not appear to play a strong role in shaping financial reporting behavior. Although foreign investors are typically viewed as effective monitors who encourage better governance (Jensen & Meckling, 1976), their influence in the context of SOEs is limited. The study found that foreign shareholding remained low and stable, while financial reporting integrity varied independently. This suggests that the involvement of foreign investors likely in a passive or portfolio role has not reached a level that can impact internal reporting practices. These findings echo the views of Kao et al. (2019) and support Afrilia and Surifah (2023), while offering a different perspective from Beuselinck et al. (2017), who highlight the positive oversight function of foreign ownership in more market-driven settings.

Earnings quality does not appear to amplify or diminish the impact of financial risk on reporting integrity. Despite agency theory proposing that credible earnings figures could signal financial health and increase accountability (Jensen & Meckling, 1976), the data here suggests otherwise. With earnings quality fluctuating dramatically and financial risk remaining relatively constant, the relationship between the two lacked alignment. In this case, earnings quality did not function as a tool to reinforce risk-related pressures on reporting integrity. This may reflect the layered regulatory environment within SOEs, where the effects of traditional financial signals are diluted by external governance.

In contrast, earnings quality strengthens the positive influence that profitability has on financial reporting. When a company generates profits and these earnings are of high quality, management appears more confident in producing transparent and credible reports. The combination of strong performance and reliable earnings gives assurance to stakeholders and enhances trust in the reporting process. This aligns well with the agency theory framework, where high earnings quality supports better alignment between internal decision-making and stakeholder expectations (Jensen & Meckling, 1976). These insights align with those of Fatima et al. (2020) and Suharti and Pangestu (2023), emphasizing how quality financial outcomes can reinforce transparency.

Meanwhile, earnings quality does not seem to elevate the role of investment opportunity in improving reporting integrity. Despite assumptions that strong growth potential supported by credible earnings would lead to better disclosures (Jensen & Meckling, 1976), this pattern was not evident. Both investment opportunities and earnings quality were inconsistent and volatile, preventing a stable relationship from forming. Within the SOE framework, decision-making is less responsive to market expectations and more influenced by bureaucratic or political structures. These findings are in line with Chen et al. (2011), Khan and Watts (2009), and Bushman and Smith (2001), who point to institutional and ownership complexities as key barriers to effective signaling. However, they diverge from Alfraih and Almutawa (2017), who suggest that high-growth firms generally have more incentive to enhance reporting when supported by quality earnings.

Finally, the presence of strong earnings quality appears to reduce the influence of foreign ownership in driving financial reporting integrity. Although foreign investors are expected to act as external monitors, the data shows that when earnings are already of high quality, the added role of foreign ownership becomes less apparent. Rather than reinforcing each other, earnings quality and foreign ownership seem to operate independently—at times even substituting for one another in shaping reporting practices. This likely reflects the passive nature of foreign investment in SOEs, where external shareholders have limited ability to influence corporate governance. This interpretation aligns with Rashid et al. (2021), who note that the oversight power of foreign investors depends heavily on their level of involvement. These results contrast with Beuselinck et al. (2017) and Afrilia and Surifah (2023), who found that foreign ownership strengthens reporting quality—albeit in more active governance environments.

6. Conclusions

This research concludes that of the four independent variables tested, only profitability proved to contribute positively to financial reporting integrity in SOE companies in Indonesia. Meanwhile, financial risk, investment opportunity set, and foreign ownership do not show meaningful contributions, indicating that these three have not become main factors in driving financial reporting integrity in this research. Furthermore, earnings quality can encourage the positive relationship between profitability and financial reporting integrity, while its role in other variables is inconsistent, even tending to suppress the contribution of main variables. These findings indicate that financial reporting integrity in Indonesia's SOEs 2021-2024 in this research is more influenced by internal factors and regulations based on actual performance compared to pressure from investors or markets.

Based on the findings, companies are advised to continue focusing on strengthening financial reporting systems on profit performance and earnings quality aspects, considering that profitability and earnings quality prove to contribute to driving financial reporting integrity. Operational performance improvement strategies need to be implemented sustainably, accompanied by training and supervision that ensures earnings quality is maintained, so that presented financial information reflects actual conditions and builds stakeholder trust. On the other hand, for financial risk, investment opportunity set, and foreign ownership, companies still need to pay attention to these aspects strategically, because stability of funding structure, investment opportunities, and foreign shareholder involvement have the potential to become supporting factors if managed more adaptively and responsively to market dynamics. For future research, approaches can be expanded by examining strategic sectoral characteristics and exploring other general financial variables such as cost structure, asset efficiency, or budget governance, which may have closer links to reporting integrity in SOE managerial and institutional contexts.

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