THE LINK AMONG PRIOR EARNINGS QUALITY, CURRENT REPUTATION AND FUTURE FINANCIAL PERFORMANCE

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Abstract - Prior earnings quality is a determinant of subsequent financial performance, and as a cause of current firm reputation. This research attempted to explore the effect of prior earnings quality on current firm reputation and subsequent financial performance; especially it tried to investigate the mediating role current firm reputation plays in the causal link from prior earnings quality to subsequent financial performance. The empirical findings offer statistical evidence that prior earnings quality significantly affects subsequent financial performance, as well as current firm reputation, which in turn mediates the causal association between prior earnings quality and subsequent financial performance. This research is expected to offer directors with a more comprehensive understanding of the complicated relationship among earnings quality, financial performance and firm reputation. This will enable them to make better business decisions on the reliable level of reported earnings and on the level of investment in the enhancement of their firm reputation to the degree that their firms could achieve the best financial performance in the future.

Index Terms - Corporate Finance, Earnings Quality, Ethical Behavior, Firm Reputation, Financial Performance

I. INTRODUCTION

Financial information scandals have increasingly attracted public concern, which because undermine confidence in stock exchanges, auditors, executive directors, bankers and even local governments among the users of accounting information such as shareholders and other involved stakeholders (Sanders et al. 1996). The importance of public prejudices derived from earnings management should be taken into account (Wu 2010). Earnings management is vital ethical earnings reporting issue related to ethical behaviors of the executive directors (Armstrong 1993). Most previous empirical studies on earnings management have normally regarded earnings management as closely related to earnings quality (Ewert and Wagenhofer 2012), in which a high magnitude of earnings management implies a low quality of reported earnings. The management of earnings is the practice of manipulating earnings reports of a firm (Kulane and Kariuki 2018). It has been broadly accepted as a determined interference in the externally financial reporting practice with the intention to attain some self-interests by the executive directors (Schipper et al. 1989). The purpose of this is to meet the managerial objective of satisfying financial analysts' expectations, misleading investors, maintaining the economically growing projector or achieving the prearranged objective incomes for the compensation, premium or bonus (Leuz et al. 2003). Earnings quality is considered as one of the significant indices for exactly assessing a firm's value and a better quality of earnings will provide more useful information of financial performance, which is so important for investors, shareholders or other stakeholders to make good decisions on their businesses (Machdar et al. 2017).

Prior studies have investigated the relationships among earnings quality, financial performance and firm reputation (Huynh 2018). Earnings quality was confirmed a driver of subsequent firm reputation, which is related to upcoming financial performance (Johnson et al. 2014; Leggett et al. 2016). Furthermore, the effect of earnings quality on future financial performance has broadly been discussed in previous research (Chan et al. 2006; Latif et al 2017; Huynh 2018). Nevertheless, these studies have only examined the causal links from earnings quality to firm reputation and financial performance or the causal linkage from firm reputation to financial performance. To the best of our knowledge, no previous research has explored the mediation of firm reputation on the causal relationship from the quality of earnings to financial performance. Therefore, the purpose of this paper was to connect firm reputation to both earnings quality and financial performance and then establish the mediatory function of firm reputation in the causal relation between earnings quality and financial performance.

The rest of this paper is organized as follows. Part 2 will synthesize the literature of earnings quality, firm reputation and financial performance and develop the research hypotheses; Part 3 will describe the data collection and the statistical techniques applied to analyze the collected data; Part 4 will offer some empirical findings followed by the final Part that will

give some conclusions and discussions.

II. LITERATURE REVIEW

From previous research, earnings quality is a determinant of financial performance; on the other hand it also affects firm reputation, which in turn improves financial performance. The connections among earnings quality, financial performance and firm reputation are more intricate than having been investigated in prior research. The more details of these complicated relationships will be explained as follows.

According to Lev (1989), the information of earnings has widely been considered one of the vital components available in financial accounting reports. Ownership diversity is regarded as an origin of higher information asymmetry (Healy and Palepu 1993). Hence, the issue of earnings quality becomes imperative before any reliance of publicly reported financial information could be based on. Previous research found that prior earnings quality is considered having positive effect on current firm reputation and subsequent financial performance that is positively affected by current firm reputation. Chan et al. (2006) proposed that there is a significantly positive influence of earnings quality on subsequent financial performance. If firms currently obtain bad financial performance and expect higher future financial performance; the directors have a tendency to 'borrow' future returns for current use; in contrast, if they currently achieve good financial performance and expect worse upcoming financial performance, their directors have a tendency to 'put aside' some present returns for potential future use (DeFond and Park 1997). These lead firms to incur larger operating expenses, damage future image and reputation, which possibly reduces subsequent financial performance, suggesting that earnings quality has a positive effect on subsequent financial performance (Taylor and Xu 2010). Meanwhile, Sloan (1996) revealed there is a significantly positive link between earnings quality and future financial performance. Firms with good earnings quality will make goodwill for themselves, which enables the firms to gain competitive advantages, the advantages that are widely recognized as a source of better subsequent financial performance. Moreover, Latif et al (2017) indicated that firms who are engaged in manipulating earnings will deliver their financial accounting reports with poor quality, which fail them to advance stakeholder satisfaction as well as cannot improve their subsequent financial performance. The manipulation of earnings is a managerial activity, the aim of which is to misstate current financial performance, so will offer imprecise financial performance for the future (Tabassum et al. 2014); which appears helpful for the current circumstance but leads to future business trouble. This can erode confidence in the firm among customers, lenders and other stakeholders. As a result, there will be a big decline in competitive advantages, leading to subsequent inferior financial performance (Teoh et al. 1998). Likewise, Gunny (2010) examining the link between the management of earnings and upcoming operating performance reported that earnings management in a firm will determine its operating performance in the future.

Previous research indicated firm reputation is dependent on managerial behaviors of the firm including earnings manipulation as a decisive element of earnings quality (Rodriguez-Ariza et al. 2016). The extent of earnings manipulation is negatively related to firm reputation (Martínez-Ferrero and Garcia-Sanchez 2016). Moreover, Kaplan and Ravenscroft (2004) confirmed that, the manipulation of reported earnings is negatively influential to the development and maintaining of potential firm reputation, which whereas is deemed to determine information received by the public about managerial behavior of the firm (Brammer and Pavelin 2004). Meanwhile, analyzing the drivers of firm environmental reputation with empirical evidence from UK, Toms (2002) stressed that the adoption, observation and disclosure of a firm's environmental policies in annual statements is one of the most important resources to the creation of environmental reputation of the firm.

In addition, the work security is one of the vital elements making incentives for executive directors to manipulate the earnings of their firms by considering comparative financial performance for both now and future, the purpose of which is to meet forecasted earning targets. Thus, these managers more possibly gain encouragements in promotion and premium (Machdar et al. 2017), which can eventually damage their firm reputation that likely leads to the dismissing of the managers. Furthermore, other research has reported the loss of support among shareholders, investors and other stakeholders, and the increasing activism and surveillance by interest groups and regulatory authorities (Zahra et al., 2005). If stakeholders do not receive appropriate results from their firm, the reputation of the firm will be destroyed, which leads to a large decrease in the attraction of external capital as well as resources (Frombun et al., 2000). Additionally, Martínez-Ferrero et al. (2016) provided statistical evidence on the negative effect of earnings management practices on firm image and reputation. Firms following the manipulation of

earnings will suffer the loss of support from investors, lenders, shareholders and other stakeholders and then will create a harmful influence on firm reputation (Martínez-Ferrero and Garcia-Sanchez 2016). The apparent disclosure of a firm's financial reports will help its stakeholders avoid the financial information asymmetries, which likely improves belief among them. It can therefore augment firm image and brand advancing future firm reputation (Martínez-Ferrero et al. 2016, Rodriguez-Ariza et al. 2016). Other research has also emphasized the negative effect of unethical accounting practices on firm reputation and organizational image (Roychowdhury 2006).

From the resource based view of the firm, it could assert that by establishing close links to key stakeholders, a firm likely builds up some intangible assets such as firm reputation to make wise use of its resources. This therefore help gain competitive advantages enabling the firm to outperform competitors in its business environment resulting in high effectiveness, profitability and sustainable growth (Roberts and Dowling 2002; Blajer-Gołębiewska and Kozłowski 2017). Establishing a good firm reputation guarantees stakeholders' continuous involvement in business; because superior firm reputation of a firm over rivals could lead it to draw the best potential workers, enhance their commitment, develop consumers' loyalty as well as bargain with lenders or suppliers at the best conditions (Surroca et al. 2010). All of them possibly create competitive advantages that are considered important elements to improve future financial performance (Ma 2000; Gatzert 2015). Furthermore, drawing on the managerial viewpoint, Ali et al. (2015) stressed the importance of firm reputation, and contended that firm reputation is widely acknowledged as an essential source of competitive advantage and as an important intangible asset that can create firm value, so obtain subsequent enhanced financial performance. A firm's good reputation could motivate shareholders and other stakeholders to accept suitable behaviors, which result in better financial effectiveness (Blajer-Golebiewska 2014; Blajer-Gołębiewska and Kozłowski 2017). Likewise, many studies regarded firm reputation as a vital indicator of the intangible resource helping to differentiate from a firm and others, which creates competitive advantages as a source of improved financial performance (Graham and Bansal 2007; Liu et al. 2016). A firm's poorly perceived social responsibility likely prevent the firm having a loan capital at the best cost of debt that means the lowest rate of interest; it can therefore suffer worse financial performance in the future (Hammond and Slocum 1996). This study bases the research model on the discussions above, which hypothesizes that firm reputation, an important driver of an organization's competitive advantage, could be an underestimated variable that can help explain more deeply the interplay between financial performance and earnings quality that is related to ethical behaviors. Based on Taghian et al. (2010), there is a strong relationship between firm reputation and firm performance and firm reputation positively affects market share of the firm. Similarly, as indicated in Li et al. (2016), good firm reputation is positively connected to expected return on investments stimulating continuous firm growth, and so results in a big augmentation in future financial performance.

In summary, as above argued, previous earnings quality likely influences current firm reputation and subsequent financial performance, which is in turn determined by current firm reputation. Furthermore, Baron and Kenny (1986) developed the mediating model in which a construct can be as a mediator to the degree to which it transmits the influence of an independent construct to a dependent construct. The mediating mechanism may occur, if the following situations exist. The independent construct uniquely affects the mediator construct significantly and also the dependent construct without the mediator construct and the inclusion of the mediator should decrease the effect of the independent construct on the dependent construct. Overall, it can assume the hypotheses below: (1) H1: The quality of previous earnings positively affects current firm reputation; (2) H2: The quality of previous earnings positively affects subsequent financial performance; (3) H3: Current firm reputation positively affects subsequent financial performance; (4) H4: Current firm reputation likely mediates the link from the quality of previous earnings to subsequent financial performance.

III. METHODOLOGY

Our sample consisted of firms that appeared in the best Vietnamese 50 firms list ranked by Forbes Vietnam during the period of 2012 – 2016. There are wholly 250 firm-year observations for this research. Of the 250 firm-year observations, there were just 239 usable firm-year observations. Firm reputation (FR) is based on the ranking levels evaluated by Forbes Vietnam. The list of the 50 best publicly listed firms employed the evaluating procedures based on the standards which Forbes used worldwide, taking into consideration the specific basics of Vietnam's business environment. The voted firms were ranked from the poor (assigning 50) to the excellent (assigning 1). Financial performance (FP) is adapted from Surroca et al. (2010) to use Tobin's q ratio as a proxy. Tobin's q ratio is basd on Latif et al. (2017) to measure by dividing the sum of the total equity market

value and total liabilities book value by the sum of the total equity book value and total liabilities book value of the firm. Earnings quality (EQ) is measured based on Perotti and Wagenhofer (2014). It was assessed with the following eight items. Two items are for 'Time-series Measure' (Persistence and Predictability); two items for 'Smoothness Measures' (Standard deviation smoothness and Correlation smoothness); two items for 'Accruals Measures' (Abnormal accruals and Accruals quality); and two items for 'Value Relevance Measures' (Earnings response coefficient and Value relevance). The causal hypotheses of 1 to 3 was tested with multiple regression analyses; whereas the mediation hypothesis of 4 is tested employing the procedures suggested by Sobel (1982).

IV. RESULTS

A. Reliability analysis

The model consists of a latent construct, the quality of earnings in $year_{t-1}$; so it was evaluated for construct consistence, applying the reliability analysis. As shown in Table 1, the item-total correlations varying from 0.537 to 0.734 all exceed 0.5, the lowest limit; furthermore, the Cronbach's α obtains 0.879, satisfying the least threshold of 0.7 (Hair et al. 2011). Besides, the Cronbachs' αs if item deleted ranging from 0.854 to 0.875 are all less than the 0.879 level, satisfying the stipulation by Hair et al. (2011). Then, the extraction method of principal component analysis with varimax was employed to calculate the compound proxy of earnings quality in $year_{t-1}$ (EQ_{t-1}).

Table 1: Reliability analysis results

Measured variables	Item-total Correlations	Cronbach's α if Item Deleted	Cronbach's α
$EQ1_{t-1}$	0.555	0.873	
$EQ2_{t-1}$	0.715	0.857	
$EQ3_{t-1}$	0.537	0.875	
$EQ4_{t-1}$	0.684	0.860	0.879
$EQ5_{t-1}$	0.622	0.867	
$EQ6_{t-1}$	0.734	0.854	
$EQ7_{t-1}$	0.649	0.864	
$EQ8_{t-1}$	0.654	0.864	

Source: Author's analyses based on the gathered data

B. Test of Causal Hypotheses 1 through 3

To test Hypothesis 1, this research regressed current firm reputation (FR_t) on prior earnings quality (EQ_{t-1}). The results are shown in Model 1 of Table 2 ($R^2 = 0.116$; $F = 31.023$; $P_f < 1\%$; $\beta = 0.329$; $P_t < 1\%$). Prior earnings quality explains 11.6% of variance in current firm reputation with F of 31.023 at the 1% significance. Prior earnings quality positively affects current firm reputation with the estimate of 0.329 at the 1% significance; in support of Hypothesis 1 that previous earnings quality positively affects current firm reputation.

Table 2: Regression analyses results

Independent variables	Dependent variables		
	FR_t (1)	FP_{t+1} (2)	FP_{t+1} (3)
Constant	2.893^{***}	2.815^{***}	0.459^{***}
EQ_{t-1}	0.329^{***}	0.570^{***}	0.251^{***}
FR_t			0.814^{***}
R^2	0.116	0.192	0.652
F	31.023	59.349	221.488
P_f	0.000	0.000	0.000

*** 1%; ** 5%; *10% Significance

Source: Author's analyses based on the collected data

To test Hypotheses 2 and 3, this research regressed subsequent financial performance (FP_{t+1}) on current firm reputation (FR_t) and prior earnings quality (EQ_{t-1}). The results are exhibited in Model 3 of Table 2 ($R^2 = 0.652$; $F = 221.488$; $P_f < 1\%$; $\beta_2 = 0.251$; $P_{t2} < 1\%$; $\beta_3 = 0.814$; $P_{t3} < 1\%$). Prior earnings quality and current firm reputation explain 65.2% of variance in subsequent financial performance with the F of 221.488 at the 1% significance. Prior earnings quality positively affects subsequent financial performance with the estimate of 0.251 at the 1% significance; in support of Hypothesis 2 that previous earnings quality positively affects subsequent financial

performance. Current firm reputation positively affects subsequent financial performance with the estimate of 0.814 at the 1% significance; in support of Hypothesis 3 that current firm reputation positively affects subsequent financial performance.

C. Test of Mediating Hypothesis 4

Table 3: Mediating analysis results

Mediating variable	Independent variable	Dependent variable	$t_{indirect}$	S.E.	P_t
FR_t	EQ_{t-1}	FP_{t-1}	4.5425	0.0589	0.000

Source: Author's analyses based on the collected data

To test Hypothesis 4, this paper conducted three models grounded on Baron and Kenny (1986). As shown in Table 2, Fs of the three models obtained 31.023, 59.349 and 221.488. P_fs of the models are all less than 1%, indicating all of the three models fit very well to the data. As indicated in Table 2; prior earnings quality alone affects current firm reputation (in Model 1); previous earnings quality alone affects subsequent financial performance with the estimate of 0.57 at the 1% significance ($R^2 = 0.192$; $F = 59.349$; $P_f < 1\%$ in Model 2) and current reputation and prior earnings quality jointly affect subsequent financial performance (Model 3). In the comparison of Models 2 and 3, the effect of prior earnings quality on subsequent financial performance in Model 2 decreases from 0.570 to 0.251 in Model 3; whereas R^2 increases from 19.2% in Model 2 to 65.2% in Model 3, which can support Hypothesis 4 on the mediating role of current firm reputation. Nevertheless, this research went on applying the procedures suggested by Sobel (1982) to test the statistical significance of the mediation. The findings in Table 3 indicate current firm reputation partially mediates the causal link from prior earnings quality to upcoming financial performance at the 1% significance level ($t_{indirect}$ = 4.5425, Std. error = 0.0589, $P < 1\%$).

CONCLUSIONS

The link among earnings quality, firm reputation and financial performance is more complex than causal relationships (Chan et al. 2006; Johnson et al. 2014; Leggett et al. 2016; Latif et al 2017; Huynh 2018). Prior earnings quality is regarded as causes of current firm reputation and subsequent financial performance that is in turn determined by current firm reputation. This could lead to the suggestion that current firm reputation likely intervenes in the causal linkage from prior earnings quality to subsequent financial performance. However, to the best of our knowledge, the mediating role of current firm reputation in that causal connection has not been investigated in previous research. Hence, this research synthesized the literature of earnings quality, firm reputation and financial performance, provided a clarification on the complicated relationship among previous earnings quality, current firm reputation and subsequent financial performance, and then proposed and explored the mediation of current firm reputation in the influence of previous earnings quality on subsequent financial performance.

The findings indicate that previous earnings quality itself affects subsequent financial performance; whereas current firm reputation is evidenced as a cause of subsequent financial performance but a consequence of previous earnings quality. Employing the procedures suggested by Sobel (1982), this research reveals that current firm reputation imposes a statistically significant mediation in the influence of previous earnings quality on subsequent financial performance. The inclusion of firm reputation leads the direct influence of prior earnings quality on subsequent financial performance to decline from the coefficients of 0.570 to 0.251, because a part of the influence is transmitted to subsequent financial performance through firm reputation.

The empirical results offer a more extensive understanding of the complicated relationship among earnings quality, firm reputation and financial performance for financial accounting researchers as well as executive directors. They should be more concerned about ethical behavior in financial accounting, because of its importance to the sustainability of their firms and had better consider firm reputation as a resource of competitive advantages resulting in subsequent financial performance. Consequently, directors ought to take more concern about ethics in financial accounting that help generate better earnings quality, which will improve stakeholders' confidence; so eventually obtain superior financial performance in the future.

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