



THE IMPORTANCE OF EARNING QUALITY AND ORGANIZATIONAL REPUTATION TO FINANCIAL EFFECTIVENESS



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ABSTRACT

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This research was to investigate the influence of previous earning quality on present organizational reputation and next financial effectiveness. Particularly, it attempted to examine the intervenient function of current organizational reputation as well as the moderating role of previous earning quality, which have been ignored. The causal relationships were tested with multiple regression; whereas the mediating influence was tested employing the procedures for indirect significance. In addition, the moderating function was tested using the interaction analyses. The results provided statistical evidence where current organizational reputation intervenes in the causal connection from previous earning quality to subsequent financial effectiveness. The moderating role of previous earning quality in the influence of current organizational reputation on next financial effectiveness was also statistically found. The findings will help managers to make superior business decisions on the reliable level of reported earning and on the level of investment in enhancing their organizational reputation to the degree that they can obtain the best possible financial effectiveness.

Contribution/ Originality: This study is one of very little research having analyzed the mediating function of organizational reputation and the moderating role of earning quality. The results indicated that, organizational reputation mediates the link between financial effectiveness and earning quality that moderates the influence of organizational reputation on effectiveness.

1. INTRODUCTION

Financial effectiveness is a subjective measure of organizational performance as well as a general measure of organizational financial health. Organizational performance in general and financial effectiveness in particular were confirmed being determined by several conditions (Wang and Huynh, 2014) especially by ethical behavior and organizational reputation (Blajer-Golebiewska, 2014; Latif *et al.*, 2017). The manipulation of earning is one of very important ethical earning reporting issues related to ethical behaviors of the executive directors (Armstrong, 1993). Most previous empirical studies on the manipulation of earning have normally regarded it as closely related to earning quality (Ewert and Wagenhofer, 2012) where a high magnitude of earning manipulation implies a low quality of reported earning. The manipulation of earning is the practice of manipulating earning 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-interest by the executive directors (Schipper, 1989). This purpose was 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). A study of Dang *et al.* (2017) examined the influence of factors on earning quality; conversely, this research tried to investigate the effect of earning quality on organizational reputation and financial effectiveness.

The quality of earning is considered as one of the significant indices for exactly assessing a firm's value and a better quality of earning will provide more useful information of financial effectiveness, which is so important for investors, shareholders or other stakeholders to make good decisions on their businesses (Machdar *et al.*, 2017). Previous research has analyzed the relationships among financial effectiveness, the quality of earning and organizational reputation (Huynh, 2018). The quality of earning was confirmed a driver of subsequent organizational reputation, which is related to upcoming financial effectiveness (Johnson *et al.*, 2014; Leggett *et al.*, 2016). In addition, the influence of earning quality on future financial effectiveness has been broadly discussed in previous research (Chan *et al.*, 2006; Huynh, 2018). However, those scholars have only examined the causal link from the quality of earning to organizational reputation and financial effectiveness or the causal linkage from organizational reputation to financial effectiveness. So far, it seems that earlier research has not investigated the mediation of organizational reputation in the causal relationship from the quality of earning to financial effectiveness as well as the moderation of the quality of earning in the causal relationship from organizational reputation to financial effectiveness. Furthermore, Manzano *et al.* (2014) stressed that the quality of earning in emerging economies is still undependable, although these economies are urgent to attract foreign investment; therefore it is essential to do more research on earning management there. Accordingly, the purpose of this project was to establish the mediatory role of organizational reputation in the causal relation between the quality of earning and financial effectiveness and then link the moderating function of earning quality to the causal relationship between organizational reputation and financial effectiveness in Vietnam as an emerging country.

2. MATERIALS AND METHODS

2.1. Hypotheses

Ethical behavior of firms has caused numerous financial information scandals that 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 earning management should be taken into consideration (Wu, 2010). The association among financial effectiveness, earning quality and organizational reputation is more complex than having been acknowledged. These complicated relationships will be detailed later on. Lev (1989) indicated that, the information of earning has widely been considered one of the vital components available in financial accounting reports. Ownership diversity was regarded as an origin of higher information asymmetry (Healy and Palepu, 1993). Consequently, the issue of earning quality has become imperative before any reliance of publicly reported financial information could be based on. Previous research found that prior earning quality is considered having positive effect on current organizational reputation and subsequent financial effectiveness that is positively affected by current organizational reputation. Based on Chan *et al.* (2006) there was a significantly positive influence of earning quality on subsequent financial effectiveness. If firms currently obtain bad financial effectiveness and expect higher future financial effectiveness; the directors have a tendency to 'borrow' future returns for current use; in contrast, if they currently achieve good financial effectiveness and expect worse upcoming financial effectiveness, their directors have a tendency to 'put aside' some present returns for potential future use (DeFond and Park, 1997). These enabled firms to incur larger operating expenses; damage future image and reputation, which possibly reduces subsequent financial effectiveness, suggesting that the quality of earning has

a positive influence on subsequent financial effectiveness (Taylor and Xu, 2010).

In the meantime, according to Sloan (1996) there was a significantly positive link between earning quality and future financial effectiveness. Firms with the good quality of earning 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 effectiveness. Furthermore, Latif *et al.* (2017) pointed out that firms who are engaged in manipulating earning will deliver their financial accounting reports with poor quality, which fail them to advance stakeholder satisfaction as well as cannot improve their subsequent financial effectiveness. The manipulation of earning is a managerial activity, the aim of which is to misstate current financial effectiveness, so will offer imprecise financial effectiveness 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 firm performance (Teoh *et al.*, 1998; Liu, 2016). Similarly, Gunny (2010) investigating the connection between the manipulation of earning and upcoming operating effectiveness reported that earning manipulation in a firm will decide its future operating effectiveness. Furthermore, organizational reputation is contingent on managerial behaviors of the firm including earning manipulation as a decisive element of earning quality (Rodríguez-Ariza *et al.*, 2016). The extent of earning manipulation is negatively related to organizational reputation (Martínez-Ferrero and Garcia-Sanchez, 2016).

Additionally, Kaplan and Ravenscroft (2004) confirmed that, the manipulation of reported earning is negatively influential to the development and maintaining of potential organizational 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 firm's creation of environmental reputation.

Besides, the work security is one of the vital elements making incentives for executive directors to manipulate the earning of their firms by considering comparative financial effectiveness 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 organizational reputation that likely leads to the dismissing of the managers. Moreover, other research has indicated the lack of support among owners and other stakeholders, as well as the rising activism by interest groups (Zahra *et al.*, 2005). If stakeholders receive unsuitable outcomes from their firm, their firm's reputation will be destroyed, leading to a large decrease in the attraction of external capital and resources (Fombrun *et al.*, 2000).

Furthermore, Martínez-Ferrero *et al.* (2016) provided statistical evidence on the negative effect of earning manipulation practices on firm image and reputation. Firms following the manipulation of earning will suffer the loss of support from investors, lenders, and shareholders as well as other stakeholders and then will create a harmful influence on organizational 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 organizational reputation (Martínez-Ferrero *et al.*, 2016; Rodríguez-Ariza *et al.*, 2016).

Other research has also emphasized the negative effect of unethical accounting practices on organizational reputation and organizational image (Roychowdhury, 2006). Drawing on the resource-based view, it could emphasize that, by establishing close links to key stakeholders, a firm likely builds up some intangible assets such as organizational 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, 2016).

Setting up a good organizational reputation guarantees stakeholders' continuous involvement in business;

because superior organizational 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 effectiveness (Ma, 2000; Gatzert, 2015).

Furthermore, drawing on the managerial viewpoint, Ali *et al.* (2015) stressed the importance of organizational reputation, and contended that organizational 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 effectiveness. 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-Golebiewska and Kozłowski, 2016).

Evenly, many studies regarded organizational 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 effectiveness (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 effectiveness in the future (Hammond and Slocum, 1996). This study bases the research model on the discussions above, which theorizes that organizational 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 effectiveness and earning quality that is related to ethical behaviors.

Derived from Taghian *et al.* (2010) there was a strong relationship between organizational reputation and firm performance and organizational reputation positively affects market share of the firm. Similarly, as indicated in Li *et al.* (2016) good organizational reputation was positively connected to expected return on investments stimulating continuous firm growth, and so results in a big augmentation in future financial effectiveness. To sum up, as earlier discussed, previous earning quality likely influences current organizational reputation and subsequent financial effectiveness, which is in turn determined by current organizational reputation. Therefore, it is recommended that previous earning quality can be a moderator in the causal link from current organizational reputation to subsequent financial effectiveness. In addition, Baron and Kenny (1986) established 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. In general, it could recommend the following five hypotheses:

H1: The quality of previous earning positively affects current organizational reputation

H2: The quality of previous earning positively affects subsequent financial effectiveness

H3: Current organizational reputation positively affects subsequent financial effectiveness

H4: Current organizational reputation likely mediates the causal link from the quality of previous earning to subsequent financial effectiveness

H5: The quality of previous earning likely moderates the causal connection between current organizational reputation and subsequent financial effectiveness

2.2. Data Collection and Analyses

The research sample was composed of companies which registered on 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. Organizational reputation (OR) 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 effectiveness (FE) is adapted from [Surroca et al. \(2010\)](#) to use Tobin's q ratio as a proxy. Tobin's q ratio is calculated 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. Earning quality (EA) is measured based on [Perotti and Wagenhofer \(2014\)](#). It is 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' (Earning response coefficient and Value relevance). The causal hypotheses of 1 to 3 was tested with multiple regression analyses; whereas the mediating hypothesis of 4 was tested employing the procedures recommended by [Sobel \(1982\)](#). In addition, the moderating hypothesis of 5 was tested using the interaction as suggested by [Baron and Kenny \(1986\)](#).

3. RESULTS AND DISCUSSION

3.1. Reliability Analysis

Table-1. Reliability analysis.

Measured variables	Item-total Correlations	Cronbach's α if Item Deleted	Cronbach's α
EA1 _{t-1}	0.555	0.873	0.879
EA2 _{t-1}	0.715	0.857	
EA3 _{t-1}	0.537	0.875	
EA4 _{t-1}	0.684	0.860	
EA5 _{t-1}	0.622	0.867	
EA6 _{t-1}	0.734	0.854	
EA7 _{t-1}	0.649	0.864	
EA8 _{t-1}	0.654	0.864	

Source: Author's analyses.

There is a latent construct, the quality of earning in year_{t-1}, in the research models; as a result, it was assessed for measurement consistence, employing 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 0.7⁴⁸. Besides, the Cronbachs' α s 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. \(2011\)](#). Subsequently, to calculate the compound proxy of earning quality in year_{t-1} (EA_{t-1}), this research applied the extraction method of principal component analysis with varimax. There are three independent variables in the research models, current organizational reputation, the quality of earning in year_{t-1} and subsequent financial effectiveness, it is necessary to test the multicollinearity in the research model by calculating the correlations between independent variables. The results are displayed in [Table 2](#). The correlations between pairs of independent variables range from 0.341 to 0.502; all of which are smaller than the 0.7 lowest threshold proposed by [Kennedy \(2003\)](#) therefore, it could conclude no multicollinearity in the research models.

3.2. Analyses of Causal Hypotheses

Table-2. Correlations.

	OR _t	EA _{t-1}	Interaction
OR _t	1	0.341***	0.602***
EA _{t-1}		1	0.548***
Interaction			1

*** 1% Significance

Source: Author's analyses.

Hypothesis 1 was investigated by regressing current organizational reputation (OR_t) on prior earning quality (EA_{t-1}), producing the findings as revealed in Model 1 of Table 3 ($R^2 = 0.116$; $F = 31.023$; $P_f = 0.000$; $\beta = 0.329$; $P_t = 0.000$). Prior earning quality explains 11.6% of variance in current organizational reputation with F of 31.023 at the 1% significance.

Prior earning quality positively affects current organizational reputation with the estimate of 0.329 at the 1% significance; in support of Hypothesis 1 that earlier earning quality imposes a positive impact on present organizational reputation; which is consistent with those in Martínez-Ferrero *et al.* (2016).

Table-3. Regression analyses.

Explanatory variables	Explained variables		
	OR_t (Model 1)	FE_{t+1} (Model 2)	FE_{t+1} (Model 3)
C	2.893***	2.815***	0.459***
EA_{t-1}	0.329***	0.570***	0.251***
OR_t			0.814***
Rsquare	0.116	0.192	0.652
F	31.023	59.349	221.488
Sig.	0.000	0.000	0.000

*** 1% Significance
Source: Author's analyses.

Hypotheses 2 and 3 were tested by regressing subsequent financial effectiveness (FE_{t+1}) on current organizational reputation (OR_t) and prior earning quality (EA_{t-1}). The results are exhibited in Model 3 of Table 3 ($R^2 = 0.652$; $F = 221.488$; $P_f = 0.000$; $\beta_2 = 0.251$; $P_{t2} = 0.000$; $\beta_3 = 0.814$; $P_{t3} = 0.000$). Prior earning quality and current organizational reputation explain 65.2% of variance in subsequent financial effectiveness with the F of 221.488 at the 1% significance. Prior earning quality positively affects subsequent financial effectiveness with the estimate of 0.251 at the 1% significance; in support of Hypothesis 2 that previous earning quality positively affects subsequent financial effectiveness.

Current organizational reputation positively affects subsequent financial effectiveness with the estimate of 0.814 at the 1% significance; in support of Hypothesis 3 that current organizational reputation has a positive influence on following financial effectiveness.

3.3. Analyses of Mediating Hypothesis

Hypothesis 4 was examined with three models grounded on Baron and Kenny (1986). As shown in Table 3, F s of the three models obtained 31.023, 59.349 and 221.488. P s of the models are all less than 1%, indicating all of the three models fit very well to the data.

As indicated in Table 3; prior earning quality alone affects current organizational reputation (in Model 1); previous earning quality alone affects subsequent financial effectiveness with the estimate of 0.57 at the 1% significance ($R^2 = 0.192$; $F = 59.349$; $P_f = 0.000$ in Model 2) and current reputation and prior earning quality jointly affect subsequent financial effectiveness (Model 3).

Table-4. Mediating analysis.

Mediator	Explanatory variable	Explained variable	$t_{indirect}$	P_t
OR_t	EA_{t-1}	FE_{t-1}	4.5425	0.000

Source: Author's analyses.

In the comparison of Models 2 and 3, the effect of prior earning quality on subsequent financial effectiveness 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 organizational 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 4 indicate current organizational reputation partially mediates the causal link from prior earning quality to upcoming financial effectiveness at the 1% significance level ($t_{\text{indirect}} = 4.5425$, $P_t = 0.000$).

3.4. Analyses of Moderating Hypothesis

Table-5. Moderating analysis.

Explanatory variables	Explained variable	
	FE _{t+1} (Model 3)	FE _{t+1} (Model 4)
C	0.459***	0.585***
EA _{t-1}	0.251***	0.137*
OR _t	0.814***	0.751***
Interaction		0.053**
Rsquare	0.652	0.659
F	221.488	151.136
Sig.	0.000	0.000
Test of increases in Rsquare	Δ Rsquare = 0.7%; $P_c = 0.040$	

*** 1%; ** 5%; *10% Significance
Source: Author's analyses.

Hypothesis 5 was tested by employing Model 3 in Table 3 and afterward including the interaction between prior earning quality and current organizational reputation into the chief influence in Model 4 as shown in Table 5. To weaken multicollinearity, before producing the interaction element, explanatory and moderating factors ought to be centered (Wilson, 2010).

The figures in Table 5 demonstrate that, the increase in Rsquare (Δ Rsquare) due to the interaction element is significant at the 5% statistics value. The research model gains the 65.9% explanatory power at the 1% statistical significance. The effect of the interaction on financial effectiveness is statistically significant at the 5% threshold with the 0.053 coefficient. The empirical results offer statistical support for the moderating Hypothesis 5, stating that: The quality of previous earning moderates the causal connection between current organizational reputation and subsequent financial effectiveness.

4. CONCLUSIONS

The relationships between organizational reputation, financial effectiveness and earning quality are more comprehensive than causal linkages investigated in prior research (Chan *et al.*, 2006; Johnson *et al.*, 2014; Leggett *et al.*, 2016; Latif *et al.*, 2017; Huynh, 2018). Preceding earning quality is regarded as a vital determinant of existing organizational reputation and succeeding financial effectiveness also affected by existing organizational reputation. That possibly will result in the proposition that present organizational reputation can mediate the underlying connection between following financial effectiveness and earlier earning quality that could in turn moderate the relationship between present organizational reputation and following financial effectiveness. Nevertheless, it seems that, the intervenient function of existing organizational reputation and the moderating role of earlier earning quality have not been examined.

Therefore, this work synthesized the literature of financial effectiveness, earning quality and organizational reputation, and then offered a detailed explanation in the intricate correlation among earlier earning quality, successive financial effectiveness and present organizational reputation. It then investigated the intervention of present organizational reputation in the impact of preceding earning quality on following financial effectiveness as well as the moderation of previous earning quality in the influence of present organizational reputation on following financial effectiveness. The empirical results reveal that prior earning quality itself influences succeeding financial effectiveness; whereas present organizational reputation is documented as a driver of following financial effectiveness but a consequence of prior earning quality.

Drawing on the analyses as Sobel (1982) stipulated, this work discloses that present organizational reputation puts a statistically significant mediation on the effect of preceding earning quality on succeeding financial effectiveness.

The insertion of organizational reputation enables the direct effect of previous earning quality on successive financial effectiveness to decrease down to 0.251 from 0.570 due to a part of the effect is transmitted to following financial effectiveness through current organizational reputation. Following the procedures as Baron and Kenny (1986) suggested, it reveals that preceding earning quality imposes a statistically significant moderation on the effect of present organizational reputation on succeeding financial effectiveness. This research has therefore contributed to managerial knowledge by discussing and offering statistical evidence on the mediation of organizational reputation and the moderation of earning quality, which have been ignored in previous studies.

5. SIGNIFICANCE STATEMENT

This research provided a more widespread understanding of the intricate association among financial effectiveness, earning quality and organizational reputation for managerial researchers as well as business managers.

It will help them to be more concerned about ethical behaviour in accounting reports, due to its importance to the development in their organizations. The business managers should regard organizational reputation as their firm's resource of competitive advantages, which can leads to better succeeding financial effectiveness. Accordingly, the managers are supposed to pay more concern about ethics in accounting task, which will create better earning quality that can then advance stakeholders' confidence; consequently ultimately acquire superior subsequent financial effectiveness.

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