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Determinant of Capital Structure and Earning Quality: Evidence from Indonesian Listed Commercial Banks, 2008–2024

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ABSTRAK

This study investigates the determinants of capital structure and their implications for earnings quality in Indonesian listed commercial banks. Using panel data from eight banks on the Indonesia Stock Exchange (2008–2024) and applying Structural Equation Modeling (SEM), the research analyzes the direct and indirect effects of firm size and earnings management on capital structure and earnings quality. The results show that firm size does not significantly affect capital structure, indicating that larger banks tend to prioritize internal funding over external debt. In contrast, earnings management exerts a significant positive influence on capital structure, suggesting its relevance in shaping financing decisions. However, earnings management does not directly enhance earnings quality, reflecting the influence of regulatory oversight and governance frameworks in limiting discretionary reporting practices. Capital structure is identified as the strongest determinant of earnings quality, demonstrating a substantial positive effect while also mediating the relationships among firm size, earnings management, and earnings quality. These findings underscore the importance of maintaining balanced leverage to strengthen financial discipline, monitoring mechanisms, and reporting credibility. The study contributes sector-specific evidence from an emerging market and provides practical insights for banking practitioners, regulators, and investors regarding financial strategy, governance, and transparency.

Keywords: capital structure, earnings management, earnings quality, SEM, Indonesian banking sector.

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INTRODUCTION

Capital structure and earnings quality are essential pillars of financial sustainability and institutional credibility, particularly in the banking sector, which serves as a key driver of economic stability. An optimal capital structure minimizes the cost of capital and enhances firm value (Modigliani & Miller, 1958), whereas high earnings quality strengthens financial statement reliability and reinforces stakeholder confidence (Dechow & Dichev, 2002). Despite extensive theoretical and empirical research, the interactions among firm size, earnings management, capital structure, and earnings quality remain inconclusive, particularly in emerging markets such as Indonesia, where institutional frameworks and governance standards differ significantly from developed economies.

In Indonesia, the banking industry plays a vital role in sustaining financial stability and promoting long-term economic growth. However, repeated cases of financial misrepresentation and accounting irregularities have raised serious concerns regarding corporate transparency and governance practices. For example, Kontan.id (2020) reported that PT Timah (TINS) overstated its 2018 net profit by recording IDR 531.35 billion instead of the actual IDR 132.29 billion (Azzahra & Afiqoh, 2024). Such incidents misled investors and distorted financial decision-making, highlighting the ongoing challenges of earnings management and the need for stronger regulatory enforcement and transparent reporting mechanisms.

Prior studies provide mixed and often contradictory evidence concerning the influence of firm-specific characteristics and managerial discretion on financial outcomes. Larger firms typically have greater access to external financing, benefit from economies of scale, and are subject to more intensive oversight by regulators and auditors, which collectively foster higher earnings quality (Di Fabio et al., 2021; Gur et al., 2023). Conversely, smaller firms face financing constraints and weaker monitoring systems, making them more prone to earnings management practices (Healy & Wahlen, 1999; Schipper, 1989). The Trade-Off Theory posits that firms aim to balance the tax advantages of debt against the costs of financial distress, while the Pecking Order Theory argues that firms prefer internal funds before seeking external financing (Frank & Goyal, 2008; Yıldırım & Çelik, 2021). However, recent findings suggest that these theoretical predictions may not fully apply in emerging markets, where institutional development and governance quality differ significantly (Mini et al., 2025; Lopes et al., 2023; Rahman et al., 2024).

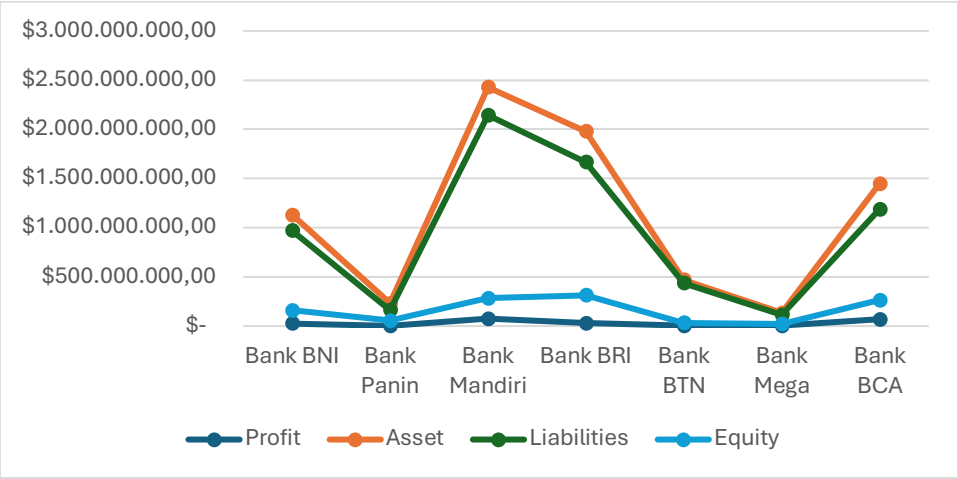
Earnings management, as an exercise of managerial discretion, involves modifying accounting estimates or judgments to influence reported performance (Burlacu et al., 2024; Kamau & Murori, 2024). While such

practices may temporarily enhance profitability, excessive or opportunistic manipulation undermines financial credibility and distorts the link between leverage and firm performance (Bartov et al., 2018; Shoaib & Siddiqui, 2022). In the banking sector, where transparency, accountability, and compliance are critical, earnings manipulation can severely erode institutional trust (Nimani et al., 2022; Biehl et al., 2024). Therefore, examining the interactions among firm size, earnings management, and capital structure becomes essential for understanding their combined implications on earnings quality, especially within regulated financial systems.

Empirical observations from Indonesia's publicly listed commercial banks further validate these conceptual linkages. Data on total assets, liabilities, and equity indicate that larger institutions, such as Bank Mandiri, Bank Rakyat Indonesia (BRI), and Bank Central Asia (BCA), tend to achieve higher profitability and maintain stronger leverage positions. Conversely, smaller banks, including Bank Mega, Bank Panin, and Bank BTN, exhibit lower profitability and smaller asset bases, suggesting that firm size correlates positively with both leverage capacity and operational efficiency.

To provide an overview of the financial conditions of the sampled banks, this study presents descriptive statistics on profits, total assets, liabilities, and equity, as shown in Table 1.

Table 1. Total Assets, Earnings, Liabilities, and Equity Commercial Banks in Indonesia, Period 2024



Source: Data Processed

Despite these empirical insights, studies focusing specifically on capital structure determinants and their implications for earnings quality in Indonesia's banking sector remain scarce. Prior research has largely concentrated on manufacturing and non-financial firms, neglecting the unique prudential and regulatory environment of banks, institutions.

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Accordingly, this study aims to examine how firm size and earnings management affect the capital structure and earnings quality of Indonesian commercial banks listed on the Indonesia Stock Exchange (IDX) over the 2008–2024 period. Employing Structural Equation Modeling (SEM), the research seeks to analyze both direct and indirect relationships among the variables while integrating sector-specific indicators such as the Capital Adequacy Ratio (CAR) and the equity-to-assets ratio. The study contributes to the literature by providing sector-specific evidence from an emerging market perspective and offers practical insights for policymakers, regulators, and banking practitioners in strengthening transparency, governance, and financial reporting quality within Indonesia's banking industry.

LITERATURE REVIEW

Agency Theory

Agency Theory, introduced by Jensen & Meckling (1976), explains the relationship between principals (owners) and agents (managers). The principal delegates authority to the agent to manage resources and make strategic decisions on behalf of the organization. However, conflicts arise when the agent pursues personal interests, such as maximizing bonuses, rather than acting in the best interest of the principal. This divergence of objectives leads to information asymmetry and the potential for earnings manipulation (Jensen & Meckling, 1976). Consequently, agency conflicts can diminish the reliability of financial statements and negatively affect earnings quality.

The Relationship Between Firm Size, Earnings Management, and Capital Structure

Firm size reflects the scale of a company's operations and its economic capacity (Rajabi Sarkhoni et al., 2024). Larger firms typically possess greater access to financial resources and enjoy higher credibility in the eyes of stakeholders (Handoyo et al., 2023; Gur et al., 2023). Moreover, they tend to be subject to stricter oversight by regulators, investors, and analysts, which reduces the likelihood of opportunistic financial reporting (Di Fabio et al., 2021). This heightened scrutiny discourages earnings manipulation and enhances transparency.

According to Beck & Demirguc-Kunt (2006) and Binha et al. (2020), large firms have more flexibility in managing their capital structures. The Trade-Off Theory posits that larger companies prefer debt financing due to lower bankruptcy risk and greater collateral availability, whereas the Pecking Order Theory suggests that firms prioritize internal financing before external debt (Yıldırım & Çelik, 2021). However, in emerging

markets, larger firms may rely more on retained earnings due to regulatory constraints.

H1: Firm size has a negative effect on earnings management.
H2: Firm size has a positive effect on capital structure.

The Relationship Between Earnings Management, Capital Structure, and Earnings Quality

Earnings management (EM) refers to managerial intervention in financial reporting to influence perceived firm performance (Agustia et al., 2020; Healy & Wahlen, 1999). Managers may use discretionary accruals to meet investor expectations or maintain financial ratios that satisfy lenders. Such practices can temporarily enhance access to external financing, thereby increasing leverage (Ali et al., 2015). However, excessive earnings manipulation can erode credibility and reduce earnings quality (Liu & Liang, 2024).

Agency Theory suggests that managers might exploit accounting discretion for personal gain, while Signaling Theory (Spence, 1974) posits that earnings management can serve as a signal of stability to the market if performed within acceptable limits. Nevertheless, overreliance on accrual-based earnings management undermines financial integrity, leading to lower-quality earnings.

H3: Earnings management has a positive effect on capital structure.

H4: Earnings management has a negative effect on earnings quality.

The Relationship Between Capital Structure and Earnings Quality

The Pecking Order Theory (Yıldırım & Çelik, 2021) and the Trade-Off Theory (M. Z. Frank & Goyal, 2008) explain how firms determine financing sources. Companies first use internal funds, followed by debt, and lastly equity issuance. An optimal mix of debt and equity minimizes capital costs and reduces financial distress risk. Furthermore, debt serves as a disciplinary mechanism, promoting managerial prudence and reducing opportunistic reporting behavior (Yamen & Can, 2023; Harris & Roark, 2019). Thus, capital structure can positively influence earnings quality by fostering transparency and accountability.

H5: Capital structure has a positive and significant effect on earnings quality.

The Mediating Role of Capital Structure

Capital structure often mediates the relationships between firm characteristics and financial reporting quality(Alrobai et al., 2025; Hunjra

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et al., 2020). Large firms tend to develop stronger capital bases, which indirectly improve earnings quality by ensuring financial stability (Alrobai et al., 2025; Chen et al., 2016). Similarly, earnings management can indirectly affect earnings quality through its influence on capital structure composition De Jong et al. (2008). Effective leverage management enhances monitoring mechanisms and reporting credibility in the banking industry.

H6: Capital structure mediates the effect of firm size on earnings quality.

H7: Capital structure mediates the effect of earnings management on earnings quality.

Conceptual Framework

The conceptual framework of this study is developed to illustrate the theoretical and empirical relationships among firm size, earnings management, capital structure, and earnings quality within the context of the Indonesian banking sector. Grounded in Agency Theory (Jensen & Meckling, 1976) Signaling Theory (Spence, 1974) and Capital Structure Theories, namely, the Trade-Off Theory (M. Z. Frank & Goyal, 2008) and the Pecking Order Theory (Yıldırım & Çelik, 2021), the model posits that financial structure and managerial discretion jointly influence the credibility and sustainability of reported earnings.

Theoretical Rationale

Theoretical Rationale **Firm size is expected to influence the extent of earnings management practices within banking institutions.** Larger banks typically maintain stronger internal control systems and are subject to more rigorous regulatory oversight**, reducing managerial discretion to manipulate financial reports (**H1**). This relationship aligns with the** Agency Theory**, which posits that enhanced monitoring mechanisms in larger firms constrain opportunistic behavior and promote transparent reporting.**

The linkage between firm size and capital structure reflects resource capability and financing flexibility. Larger entities possess stronger collateral capacity and market access, enhancing their ability to maintain higher leverage levels (H2). This finding supports the Trade-Off Theory, emphasizing that firm scale mitigates bankruptcy risk and fosters stable debt utilization (Al-Qudah, 2023)

The interaction between earnings management and capital structure demonstrates strategic alignment between reporting discretion and financing policy. Managers may enhance perceived performance through earnings adjustments, signaling stability and creditworthiness that facilitate debt acquisition (H3). This aligns with Signaling Theory, which posits that earnings-based signals, whether genuine or managed, can

influence external perceptions and funding access (Puspitaningtyas, 2019; Steigenberger et al., 2025).

The relationship between earnings management and earnings quality reveals the inherent trade-off between discretion and reliability. Excessive accrual manipulation undermines informational transparency and distorts performance indicators, leading to diminished predictive value and stakeholder confidence (H4). This observation is consistent with the Earnings Quality Concept Theory (Dichev et al., 2012) and recent findings by (Meyer & Dutzi, 2024; Rahman et al., 2024), who emphasize that earnings transparency strengthens market confidence across emerging economies.

Capital structure constitutes a governance mechanism that enhances financial discipline and reporting credibility. An optimal leverage ratio fosters external monitoring, constraining opportunistic behavior and reinforcing reporting integrity (H5). This supports both Trade-Off and Agency Theories, underscoring that moderate debt operates as a disciplinary instrument aligning managerial behavior with stakeholder interests (Kraus & Litzenberger, 1973).

Firm size indirectly enhances earnings quality via the mediating role of capital structure, as larger banks typically adopt more efficient leverage policies that reinforce both financial discipline and transparency (H6). This pathway extends the Trade-Off Theory, linking firm scale to enhanced governance through leverage optimization within regulated banking contexts.

Capital structure mediates the link between earnings management and earnings quality by introducing external monitoring pressures and contractual obligations that curb managerial opportunism (H7). This finding reinforces the Agency Theory, positioning debt as a disciplinary mechanism ensuring managerial accountability and integrity in financial reporting.

Collectively, these relationships form an integrated theoretical framework connecting firm characteristics, managerial discretion, and financing decisions to earnings quality. These linkages collectively extend the theoretical boundaries of traditional capital structure theories by contextualizing them within regulated emerging banking markets, where regulatory structures and governance intensity reshape the leverage-earnings quality nexus.

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Conceptual Model Diagram

The following diagram illustrates the hypothesized relationships among firm size, earnings management, capital structure, and earnings quality

Figure 1 Research Conceptual Framework

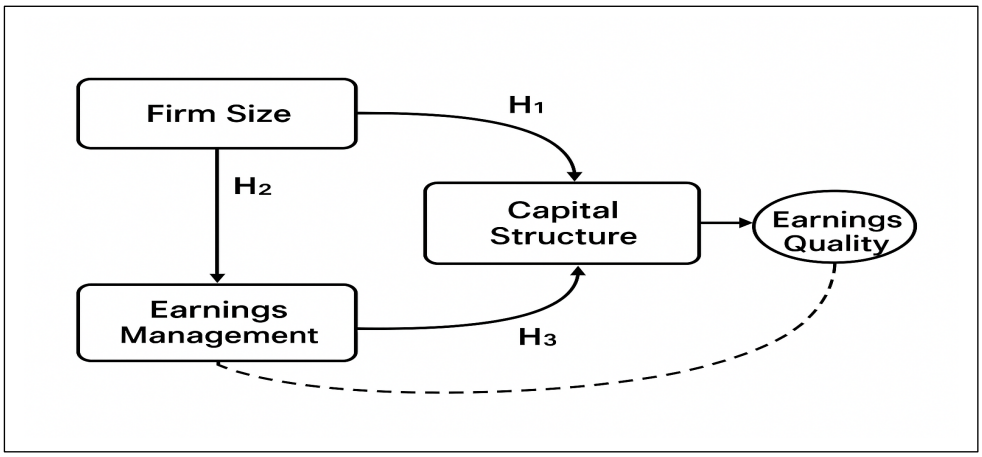

Figure 1. Conceptual Framework illustrating the hypothesized relationships among firm size, earnings management, capital structure, and earnings quality within the Indonesian banking sector, grounded in Agency, Signaling, and Trade-Off Theories.

RESEARCH METHODS

Research Design

This study adopts a quantitative explanatory research design aimed at testing causal relationships among firm size, earnings management, capital structure, and earnings quality within Indonesian listed commercial banks. The research applies Structural Equation Modeling (SEM) using AMOS version 29 to evaluate both direct and indirect (mediating) effects simultaneously. This approach allows for the analysis of complex interdependencies among financial and accounting variables, consistent with empirical methodologies in high-impact financial journals.

Research Sample and Data Collection

The population consists of all commercial banks listed on the Indonesia Stock Exchange (IDX). A purposive sampling technique was employed based on the following criteria:

1. The bank remained consistently listed on the IDX during the 2008–2024 observation period.
2. The bank published complete and audited annual financial reports for all years within the study period.
3. Data for the required research variables were fully available and reliable.

Based on these criteria, eight commercial banks met the inclusion requirements, yielding a total of 128 firm-year observations over a 16-year period. Table 1 presents the sample composition.

Table 1 Research Sample

Bank Code	Bank Code	Year of Observation	Effective Observation	Note
BBCA	Bank Central Asia Tbk	2008–2024	16	Full data
BBRI	Bank Rakyat Indonesia Tbk	2008–2024	16	Full data
BMRI	Bank Mandiri Tbk	2008–2024	16	Full data
BBNI	Bank Negara Indonesia Tbk	2008–2024	16	Full data
BBTN	Bank Tabungan Negara Tbk	2008–2024	16	Full data
MEGA	Bank Mega Tbk	2008–2024	16	Full data
BNGA	Bank CIMB Niaga Tbk	2008–2024	16	Full data
NISP	Bank OCBC NISP Tbk	2008–2024	16	Full data

Operational Definition of Variables

To ensure consistency with prior literature and empirical standards, each variable was operationalized as follows:

- Firm Size (X1): Measured using the natural logarithm of total assets (Ln Total Assets).
- Earnings Management (X2): Measured by *Discretionary Accruals (DA)* calculated using the Modified Jones Model (Patricia M. Dechow, 1995).

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Modified Jones Model for Estimating Discretionary Accruals:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha_1 \frac{1}{A_{i,t-1}} + \alpha_2 \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} + \alpha_3 \frac{PPE_{i,t}}{A_{i,t-1}} \quad (1)$$

Where:
TA = Total accruals (earnings – operating cash flow)
ΔREV = Change in revenue
ΔREC = Change in receivables
PPE = Gross fixed assets
A = Total assets of the previous year

Non-discretionary accruals (NDA) are obtained from regression estimates, while discretionary accruals (DA) are calculated as the residuals (TA/A – NDA).

- Capital Structure (Y1): Represented by the Capital Adequacy Ratio (CAR), which reflects a bank's solvency and leverage capacity.

- Earnings Quality (Y2): Measured by the accrual quality (AQ) index, calculated as:

$$AQ = \frac{1}{DA} \quad (2)$$

A higher AQ value indicates better earnings quality and lower discretionary accrual activity.

Statistical Model Specification

The SEM framework models the structural relationships among variables as follows:

Equation (1): Determinants of Capital Structure

$$Y_1 = \beta_1 X_1 + \beta_2 X_2 + \varepsilon_1 \quad (3)$$

Equation (2): Determinants of Earnings Quality

$$Y_2 = \beta_3 y_1 + \beta_4 X_2 + \varepsilon_2 \quad (4)$$

Where:
Y1 = Capital Structure
Y2 = Earnings Quality
X1 = Firm Size
X2 = Earnings Management

β_1–β_4 = Path coefficients
ε_1, ε_2 = Disturbance terms

Mediation and Indirect Effect Testing

To test for mediating effects of capital structure (Y1) between firm size (X1) and earnings quality (Y2), and between earnings management (X2) and earnings quality (Y2), the indirect effects are computed as:

- Indirect Effect (X1 → Y2 via Y1) = ß1 × ß3 (5)
- Indirect Effect (X2 → Y2 via Y1) = ß2 × ß3 (6)

The significance of these mediation effects is verified through the Sobel Test and cross-validated using bootstrapping with 5,000 resamples to ensure robustness and distributional stability.

Model Evaluation and Fit Indices

The SEM model's adequacy is assessed through multiple fit indices covering absolute, incremental, and parsimonious measures. The following criteria are applied:

Table 2 Model Goodness-of-Fit Indices and Evaluation Criteria

Index	Acceptable Threshold	Evaluation Purpose
Chi-square / df	≤ 2.00	Model parsimony
RMSEA	≤ 0.08	Approximation error
GFI, AGFI	≥ 0.90	Absolute fit
CFI, TLI	≥ 0.95	Incremental fit

A model is deemed acceptable when these indices fall within the prescribed thresholds, confirming that the empirical data sufficiently fit the hypothesized theoretical structure.

Data Estimation and Robustness Procedures

The estimation process employs the Maximum Likelihood (ML) method in AMOS version 29. The analysis treats each bank-year observation as a single data point (aggregated panel), ensuring comparability across time and institutions. To address potential cross-sectional heterogeneity and temporal dependence:

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- Bank-specific fixed effects are incorporated via dummy variables.
- Robustness checks are performed using panel regression models (Fixed Effects and Random Effects) outside the SEM framework.
- Hypothesis testing is conducted at a 5% significance level ($\alpha = 0.05$), with standardized coefficients reported for interpretability.

RESULT AND DISCCUSSION

Measurement Model

The steps taken in analyzing the data are as follows. Before testing the relationships between independent and dependent variables, a model goodness-of-fit assessment was conducted. Table 3 reports the model's goodness-of-fit indices, all of which fall within the acceptable thresholds.

Goodness of Fit Index	*Cut-off Value*	*Result*	Model Evaluation
Chi-square	Expected small	0.301	Good Fit
Probability	≥0.05	0.583	Good Fit
RMSEA	≤0.08	0.000	Good Fit
GFI	≥0.90	0.999	Good Fit
AGFI	≥0.90	0.986	Good Fit
CMIN/DF	≤2.00	0.301	Good Fit
TLI	≥0.95	1.078	Good Fit
CFI	≥0.94	1.000	Good Fit

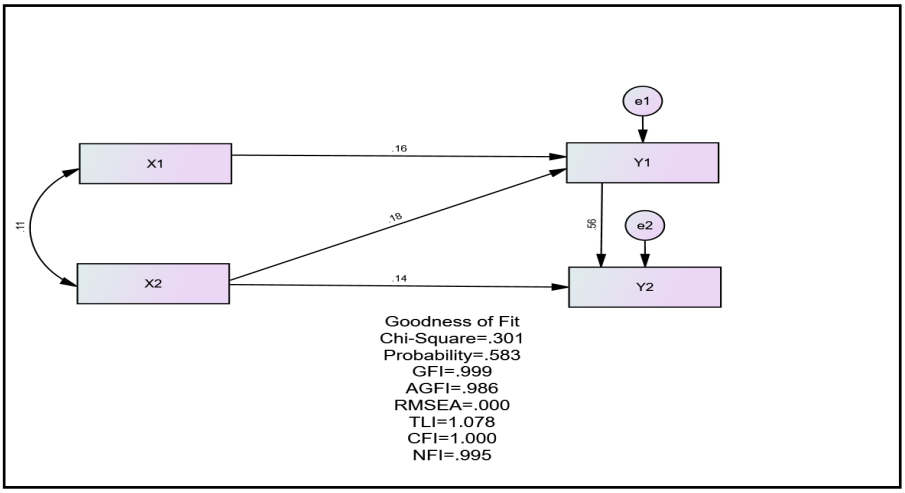
Table 3 Model Goodness Testing

Source: Data processed

Table 3 indicates that the model satisfies the required structural suitability criteria. Various indices of model fit fall within the recommended thresholds, suggesting strong alignment between the theoretical model and the empirical data. This is shown by various indicators of goodness of fit within the required range of values. Chi-Square values are 0.301 (≤ 0.911), probability is 0.583 (≥ 0.05), RMSEA is 0.000 (within the ideal range of

0.03–0.08), GFI is 0.999 (≥ 0.90), AGFI is 0.986 (≥ 0.90), CMIN/DF is 0.301 (≤ 2.00), TLI is 1.078 (≥ 0.95), and CFI is 1.000 (≥ 0.95). Based on these results, the model developed in this study was deemed feasible and demonstrated good compatibility with the research data. The framework of the Structural Equation Model can be seen in the following Figure 2:

Figure 2 Structural Equation Model



Based on Table 2, it can be concluded that the proposed model demonstrates a good overall fit and is therefore acceptable for further analysis.

Hypothesis Testing

Having confirmed the overall fit of the measurement model, the subsequent analysis examines the structural relationships among the key variables to test the research hypotheses.

Direct Effects of Firm Size (X1) and Earnings Management (X2) on Capital Structure (Y1) and Earnings Quality (Y2)

Table 4 summarizes the estimation results of direct effects among the core variables in the model.

Table 4 Results of Direct Effects (Hypothesis Testing)

Variable Relationships			Estimate	S.E.	C.R.	P-Value	R^2
Y1	<---	X1	0.101	0.06	1.69	0.091	0.65
Y1	<---	X2	0.117	0.059	1.998	0.046	

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Y2	<---	X2	0.077	0.044	1.753	0.080	0.36
Y2	<---	Y1	0.503	0.069	7.278	***	

Source: Processed data (AMOS Output, 2024)

The variation in capital structure (Y1) is explained by firm size (X1) and earnings management (X2), with an R^2 value of 0.65, indicating that 65% of the variation in capital structure is accounted for by the model. The estimated equation for the first structural path is expressed as:

$$Y1 = 0.101X1 + 0.117X2$$

The coefficient between firm size (X1) and capital structure (Y1) is positive (0.101) but statistically insignificant ($p = 0.091 > 0.05$), indicating no meaningful effect. In contrast, earnings management (X2) exerts a significant and positive effect on capital structure (Y1) ($\beta = 0.117$, $p = 0.046 < 0.05$), implying that managerial discretion in financial reporting enhances leverage decisions. Overall, variables with p-values greater than 0.05 were considered statistically insignificant.

For the second structural relationship, the variation in earnings quality (Y2) is explained by earnings management (X2) and capital structure (Y1), with an R^2 of 0.36, meaning 36% of the variation in earnings quality is explained by the model. The estimated equation for the second structural path is:

$$Y2 = 0.077X2 + 0.503Y1$$

The coefficient of earnings management (X2) on earnings quality (Y2) is 0.077 ($p = 0.080 > 0.05$), indicating a positive but statistically insignificant relationship. Conversely, capital structure (Y1) has a strong and significant positive influence on earnings quality (Y2) ($\beta = 0.503$, $p < 0.001$). This finding highlights that an optimal capital structure strengthens the credibility in summary, firm size does not exert a significant direct effect on capital structure, whereas earnings management significantly shapes leverage decisions. Capital structure, in turn, acts as a key determinant of earnings quality among Indonesian commercial banks.

Indirect Effects of Firm Size (X1) and Earnings Management (X2) on Earnings Quality (Y2) through Capital Structure (Y1)

The indirect effects were examined using the Sobel test to assess the mediating role of capital structure. Table 5 summarizes the results.

Table 5 Indirect Effects and Sobel Test Results

Relationship	Indirect	Sobel Z-value	Significance	Interpretation

	Effect			
X1 → Y1 → Y2	0.050803	1.312	< 1.96	Not significant
X2 → Y1 → Y2	0.058851	1.213	< 1.96	Not significant

Source: Processed data (AMOS Output, 2024)

The indirect effect of firm size (X1) on earnings quality (Y2) through capital structure (Y1) is 0.050803 (Sobel Z = 1.312), while the indirect effect of earnings management (X2) through capital structure (Y1) is 0.058851 (Sobel Z = 1.213). Both Z-values fall below the 1.96 threshold, indicating no significant mediating effect.

These results suggest that capital structure does not mediate the relationship between firm size and earnings management with earnings quality, indicating that their influence primarily operates through direct pathways rather than indirect mechanisms.

Total Effects

Total effects represent the sum of direct and indirect effects for each exogenous variable on the endogenous variables. This measure provides a more comprehensive understanding of the overall influence exerted by firm size and earnings management.

Table 6 Total Effects of Exogenous Variables on Endogenous Variables

Dependent Variable	Relationship	Independent Variable	Direct Effect	Indirect Effect	Total Effect
Earnings Quality (Y2)		Firm Size (X1)	–	0.050803	0.050803
Earnings Quality (Y2)		Earnings Management (X2)	0.077	0.058851	0.135851

Source: Processed data (AMOS Output, 2024)

The results reveal that firm size (X1) does not exert a direct effect on earnings quality (Y2) but demonstrates an indirect effect through capital structure (Y1) with a coefficient of 0.051, resulting in a total effect of 0.051. Although weak, this suggests that larger firms may indirectly enhance earnings quality by maintaining more stable and efficient financial structures. This implies that firm size affects earnings quality primarily through financial management mechanisms rather than direct operational performance.

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In contrast, earnings management (X2) demonstrates both direct (0.077) and indirect (0.059) effects on earnings quality (Y2), producing a total influence of 0.136. These findings imply that earnings management exerts a relatively strong overall impact on earnings quality and may also affect financial leverage, thereby influencing transparency and credibility.

Collectively, these findings illustrate the interconnectedness of firm-specific attributes, capital structure, and earnings quality. The results highlight capital structure (Y1) as a pivotal mediating mechanism linking firm size and earnings management to reported earnings quality.

Overall, the empirical results emphasize the strategic importance of maintaining an optimal and balanced capital structure to strengthen financial discipline and transparency. Effective capital management enhances monitoring mechanisms, mitigates managerial opportunism, and bolsters the credibility of financial reporting. These findings align with the Trade-Off Theory, which emphasizes balancing financial risk and performance, and the Agency Theory, which views leverage as a disciplinary mechanism that enhances earnings credibility and long-term financial stability.

DISCUSSION

This section discusses the empirical findings in light of the theoretical framework and prior research, highlighting their implications for financial governance and capital structure management in the Indonesian banking sector.

Discussion and Implications

The first hypothesis investigates the extent to which firm size determines capital structure. The findings reveal that firm size does not directly influence leverage decisions. Larger companies typically rely on internal financing through retained earnings, reducing dependence on external capital. This observation diverges from the predictions of the Trade-Off and Pecking Order Theories, which argue that larger firms are more likely to use debt due to lower bankruptcy risk (Frank & Goyal, 2008).The insignificance of firm size suggests that leverage decisions are shaped more by regulatory constraints and managerial discretion than firm scale. Evidence from Suhardjo et al. (2022) and Masyaili (2022) corroborates this result, confirming that prudential supervision and liquidity policies play a dominant role in shaping capital structure within Indonesia's banking sector.

Evidence suggests that higher levels of earnings management are linked to an increased reliance on debt financing. By enhancing reported profitability, managers send positive signals to investors and creditors,

consistent with Signaling Theory (Spence, 1974). This finding also aligns with Agency Theory (Jensen & Meckling, 1976), which explains that managerial discretion can influence leverage decisions. The results corroborate Xie et al. (2003) and Healy & Wahlen (1999), are further supported by recent evidence from Al-Qudah (2023), who demonstrated that earnings management positively influences capital structure in emerging market firms.

The findings reveal that earnings management in Indonesian banks does not significantly affect earnings quality. This divergence from Positive Accounting Theory (Watts and Zimmerman, 1990) and Agency Theory (Jensen & Meckling, 1976) underscores the dominance of regulatory and audit mechanisms that constrain managerial discretion. Oversight by Bank Indonesia, the Financial Services Authority, and independent auditors limits opportunistic behavior, resulting in higher reporting integrity. These results extend prior findings by Jameel et al. (2024) and align with Alghemary et al. (2024) and González & García-Meca (2014), who confirmed that governance quality mitigates the adverse effects of earnings management on financial transparency.

The findings corroborate the Trade-Off Theory, indicating that an optimal debt–equity balance enhances earnings quality by promoting financial discipline and external monitoring. The evidence also extends Signaling Theory (Spence, 1974) by demonstrating that leverage conveys a credible signal of stability and governance quality. This observation is consistent with Alsmady (2022), who found that well-calibrated leverage strengthens transparency and earnings persistence in emerging market banks.

Both firm size and earnings management indirectly affect earnings quality through capital structure, underscoring the mediating role of leverage as a conduit between firm characteristics and financial transparency. This interdependence refines the Trade-Off Theory by highlighting how capital structure channels firm-level behaviors into broader financial outcomes, particularly under Indonesia's regulatory constraints.

The evidence confirms the disciplinary function of debt as proposed by Agency Theory, where leverage constrains managerial discretion and strengthens reporting credibility (Huang et al., 2024). These findings also extend the Trade-Off Theory by demonstrating that optimal capital structure enhances both financial stability and earnings quality. Collectively, the results extend theoretical boundaries by showing how regulatory structures in emerging markets moderate the leverage–earnings quality nexus.

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Overall, the findings reaffirm the theoretical integration among the Trade-Off, Agency, and Signaling Theories, providing empirical evidence from an emerging market perspective that extends the global discourse on capital structure and earnings quality. From a practical standpoint, these insights emphasize the importance of aligning capital structure regulation with transparency objectives to enhance governance and investor confidence in Indonesia's banking sector.

CONCLUSION

Building upon the preceding analysis, this study concludes that the determinants of capital structure significantly shape earnings quality in the Indonesian banking sector. Using panel data from eight publicly listed commercial banks during 2008–2024, the results yield several essential insights, thereby contributing to the understanding of how firm characteristics and managerial discretion jointly influence financial structures in emerging markets.

First, the insignificance of firm size in determining capital structure suggests that larger banks prioritize internal financing and retained earnings over external borrowing. This observation diverges from the Trade-Off Theory, which predicts a positive association between firm size and leverage, implying that regulatory and prudential constraints in the Indonesian banking sector may override firm-level financing discretion.

Second, evidence indicates that higher levels of earnings management are associated with increased leverage, supporting the Signaling and Agency Theories, wherein managers use reported earnings as signals of stability to attract external financing. Nevertheless, stringent regulatory oversight and governance mechanisms appear to attenuate the adverse impact of such managerial discretion on earnings quality.

Third, the results confirm that an optimal capital structure positively and significantly enhances earnings quality. Balanced leverage fosters financial discipline, strengthens oversight mechanisms, and improves the credibility of reported earnings. Importantly, capital structure acts as a mediating channel linking firm size and earnings management to earnings quality, underscoring its pivotal role in shaping the sustainability and transparency of financial reporting within the banking industry.

The findings carry important implications for practitioners, regulators, and policymakers. Banking institutions are encouraged to maintain an optimal balance between debt and equity to safeguard earnings quality and reinforce stakeholder confidence. Regulators should strengthen supervisory frameworks to limit opportunistic reporting while promoting transparency

and accountability. For investors and creditors, capital structure remains a vital indicator for assessing the reliability of reported financial outcomes.

Overall, the significant positive effect of capital structure on earnings quality highlights the importance of capital structure optimization as a mechanism for enhancing financial transparency and reporting credibility. By maintaining prudent financing mixes, banking institutions can improve financial discipline, strengthen credibility, and ensure sustainable financial reporting practices. These findings extend the boundaries of the Trade-Off and Agency Theories by demonstrating how regulatory structures and governance intensity in emerging markets reshape the leverage-earnings quality nexus. This evidence aligns with recent findings by Zhang and Kim (2024), who emphasize that optimal leverage enhances earnings transparency across emerging market banks.

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