

# Quality of Financial Reporting: The Role of Performance and Economic Consequences

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## Abstract

*This study aims to examine the role of accounting financial reporting quality on performance and economic consequences of companies in Indonesia. The research was conducted using the SEM (Structural Equation Model) analysis technique with an alternative least squares method. By analyzing the relationship pattern between latent constructs and their indicators, latent constructs with each other, and direct measurement errors. This study uses secondary data sources on manufacturing companies listed on the Indonesia Stock Exchange. The sample of this research is 100 companies with the sampling method using probability sampling. The results of this study produce several conclusions where the company's performance has no influence on the quality of market-based financial reporting, while company performance has a significant influence on the quality of accounting-based financial reporting. As well as for the intervening effect of company performance variables on economic consequences with the intervening variable quality of market-based financial reporting and accounting, it has a significant influence where the contribution of market-based financial reporting quality and accounting is quite large rather than its direct influence.*

**Keywords:** Financial Performance, Quality of Financial Reporting, Economic Consequences

## Introduction

Financial reports are the end result of the accounting process that will be used by users of financial information in making decisions. Financial statements are an inseparable part of a company, because financial reports are one of the main media that companies can use to provide financial information to outsiders. One of the parties with an interest in the financial statements is investors (IAI, 2015). Financial information is a description of the company's performance results as a form of management accountability to shareholders. As mentioned (Hasibuan et al., 2017) said that the quality of financial reporting is very important because financial reports are a means of communicating financial information to external users. The need for financial reporting by management to shareholders is explained through agency theory. Jensen & Meckling (1976) in agency theory explains that there is a contractual relationship between the manager (agent) and the owner of the company (principal) authority in decision making is given to the manager, for this relationship an economic consequence occurs such as a conflict of interest between the owner and the agent.

Delivery Financial statements are information provided by management to investors in distinguishing companies that have good or bad quality performance which will affect the level of economic consequences in the form of asymmetric information (Fanani, 2009). The quality of the company's financial reporting can be seen from the results of the audit opinion on the company's financial statements. Audit opinion is a medium for auditors to express opinions on financial reports

to investors regarding the state of financial statements. Benefits of Financial Statements for Suppliers or Suppliers is very important. Suppliers or suppliers also have the right to know your company's financial statements, especially if you buy goods with a credit system or are not paid directly in cash. With the information presented in the report, suppliers can make decisions whether your company has the ability to pay invoices according to the nominal stated or not. If the company is deemed incapable, the supplier will refuse to cooperate with the company or can propose negotiations in this cooperation.

Benefits of Financial Statements for the Government same as important like for suppliers. Every business that is reported will have an obligation to the government to pay taxes. The amount of tax paid will be in accordance with the amount written in the financial statements owned by the business. The earlier you tidy up and prepare financial reports, you will avoid important problems related to tax obligations such as tax evasion which will be related to legal issues or deducting the insured's tax which will actually benefit the business. A company can influence society in a number of ways. For example, the number of people working in companies and protection for domestic investors. Good company financial information can help the public provide the latest information or development trends about a series of company activities.

The Investment Supervisory Board (BAPEPAM) report shows that audit opinions other than unqualified in manufacturing companies listed on the Indonesia Stock Exchange in 2011 were 7%, 2012 were 14%, 2013 were 17.5% and 2014 were 19.0%. The results of this audit opinion show

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that from year to year there has been an increase indicating that there are still many low quality company financial reports. Based on Law Number 15 of 2004 an unqualified opinion is given if the entire financial report meets five conditions according to the standards, namely: Complete financial statements (all presented), presentation in accordance with the FRF (Financial Reporting Framework), disclosure (disclosure) is complete adequate, does not contain material misstatements, and does not require the existence of things that must be excluded. The presence of violations in the disclosure of financial information will affect the audit opinion. According to (Warsono & Ardianto, 2015) the existence of violations that occurred in the submission of financial reports was caused by the failure of company management to carry out its function in choosing the accounting recording method.

## Theoretical Review

a. The relationship between company performance and the quality of financial reporting

Company management or other stakeholders can use company performance as a benchmark in determining company policy, whether the company's performance is good from a financial or non-financial perspective. Company performance can also be used to describe the effectiveness and efficiency of management in the use of company assets. Efficient contract theory between managers and company owners will form a positive relationship between accounting policies and long-term performance of companies that improve the quality of financial information (Kleins, 2002). Pre-research which is conducted by Hassan, (2013) using company performance as a factor affecting the quality of financial reporting is profitability, liquidity and company growth.

b. Profitability relationship with the quality of financial reporting

Profitability is the company's ability to earn profits as measured by the level of sales, total assets and own capital. Scott, (2015) argues that an increase in reported net income will reduce the probability of failure, so it is very possible for company managers to influence the accounting numbers in the financial statements. Research conducted by Hassan, (2013) found that profitability is positively related to the quality of financial reporting. This is also supported by research Call et al. (2016) which states that profitability affects the quality of financial reporting.

c. The relationship between liquidity and the quality of

financial reporting

Liquidity is one of the factors that can affect the accuracy of the delivery of financial reporting. According to Brigham & Houston, (2011) A high level of liquidity in a company indicates that the company can fulfill its obligations on time if the company goes into liquidation. Research conducted by Biddle et al., (2009) argues that the quality of financial reporting will increase the company's liquidity. Whereas Fanani, (2009); Hassan, (2013) found that liquidity has a significant relationship with the quality of financial reporting.

d. The relationship between company growth and the quality of financial reporting

Company growth is a change in total assets that shows the company's ability to maintain its economic position which affects accounting records. According to Biddle et al., (2009) Companies with high growth rates tend to use retained earnings in their financing and vice versa companies with lower growth rates, companies tend to use debt as a source of financing which will affect accounting reporting. Research conducted by Biddle et al., (2009); Fanani, (2009); Hassan, (2013) found that company growth has a significant and positive relationship with the quality of financial reporting.

e. The relationship between the quality of financial reporting and economic consequences

The relationship between financial reporting quality and economic consequences is explained in an economic theory called *ceteris paribus* where other factors are considered fixed. Increasing the quality of financial information will reduce information asymmetry and reduce the cost of capital (Diamond & Verrecchia, 1991; Easley & O'Hara, 2004). Holthausen & Leftwich, (1983) said the choices of accounting methods will affect the level of financial reporting which will have an impact on economic consequences.

## Research methods

The population of this study is manufacturing companies listed on the Indonesian stock exchange from 2015 to 2019. To generalize to this population, a target population is carried out, namely all companies that provide data about company performance, quality of financial reporting as well as economic consequences that amounted to 132 companies.

The operational definition of each variable and its measurement is shown as follows

Variable	definition	Measurement	Scale
Dependent Variable			
Quality of Market Based Financial Reporting	Representation of the accuracy of financial reporting with market-based measurements, namely the extent to which the financial information is responded to by the market		
Relevance (Y1.1)	The resulting financial report information can influence using estimated data for five years	$RET_{jt} = \beta_0 \text{Earnings}_{jt} + \beta_1 \Delta \text{Earnings}_{jt} + \epsilon_{jt}$ Information : $RET_{jt}$ = returns for the 15 months ending three months after the end of the company's fiscal year j year t $\text{Earnings}_{jt}$ = Company net profit j year t $\Delta \text{Earnings}_{jt}$ = Difference in company net profit j	Ratio

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		year t-1	
Timeliness (Y1.2)	Timely submission of the annual report published on the website <a href="http://www.idx.go.id">www.idx.go.id</a> Based on the Decree of the Chairman of Bapepam and LKN number Kep-134/BL/2006 concerning Obligation to Submit Annual Reports for Issuers and Public Companies which states that the deadline for submitting company annual financial statements is 90 or 91 days after the end of the financial year.	Financial reports published on the website <a href="http://www.idx.go.id">www.idx.go.id</a> less than 90 or 91 days or less from April 1 is given a value of 1 while if it is more than 90 or 91 days then it is given 0 because it is not on time. Whether or not this report has been carried out can be traced with a statement letter of submission of financial reporting uploaded at <a href="http://www.idx.com">www.idx.com</a>	Ratio
Coservatism (Y1.3)	The ability to verify the similarities and differences between two economic phenomena in order to be able to prove whether gains or losses are made using estimated data for five years.	The fixed effect value of the following equation is multiplied by -1 as a proxy for market-based conservatism $BTM_{jt} = \beta_0 + \beta_j + \beta_t + \sum_{k=0}^5 \beta_k R_{jt-k} + E_{jt}$ (Ahmad et al., 2008) Information : BTM <sub>jt</sub> = ratio of book value to market value of company j in the fiscal year ending t β = intercept of all companies and all years β <sub>i</sub> = Fixed firm-specific bias component of the book value to market value (BTM) ratio over the sample period β <sub>t</sub> = The component of the ratio of book value to market value in a certain year for all companies R <sub>jt-k</sub> = Return on shares (excluding dividends) for company j year t.	Ratio
Quality of Accounting-Based Financial Reporting (Y2)	Representation of the accuracy of accounting-based measurement financial reporting, namely: the profit generated for the current year can reflect the profit for the coming year.		
Persistence (Y2.1)	The revised earnings will come as a result of the implications for current year earnings and using estimated data for five years	The regression coefficient of the equation: $\frac{earnings_{jt}}{outstanding\ shares_{jt}} = \beta_0 + \beta_1 + E_{jt} \frac{earnings_{jt-1}}{outstanding\ shares_{jt-1}}$ Information : Earnings <sub>jt</sub> = Company net profit j year t Earnings <sub>jt-1</sub> = profit before extraordinary items Company j last year Outstanding shares <sub>jt</sub> = company j year t outstanding shares	Ratio
Predictability (Y2.2)	The ability of past earnings to predict future earnings and using estimated data for five years	The root of the error variance of the equation: $\frac{earnings_{jt}}{outstanding\ shares_{jt}} = \beta_0 + \beta_1 + E_{jt} \frac{earnings_{jt-1}}{outstanding\ shares_{jt-1}}$ Information : Earnings <sub>jt</sub> = Company net profit j year t Earnings <sub>jt-1</sub> = profit before extraordinary items Company j last year Outstanding shares <sub>jt</sub> = company j year t outstanding shares	
Income smoothing (Y2.3)	Efforts to normalize profits at the desired level and using estimated data for five years	Income smoothing $\frac{NIBE_{jt}}{CFO_{jt}}$ NIBE <sub>jt</sub> = Company net profit j year t CFO <sub>jt</sub> = Aliran kas operasi perusahaan j tahun t	Ratio
Economic Consequences (Y3)	The impact of the selection of accounting methods on investor behavior in decision making		
Information Asymmetry (Y3.1)	Conditions that show some have information while others do not have information	Spread <sub>jt</sub> = ask <sub>jt</sub> - bid <sub>jt</sub> X 100 % (ask <sub>jt</sub> + bid <sub>jt</sub> ) / 2 Information : Ask <sub>jt</sub> = The highest asking price for company j's shares that occurred in year t Bid <sub>jt</sub> = The highest offering price for company j's	Ratio

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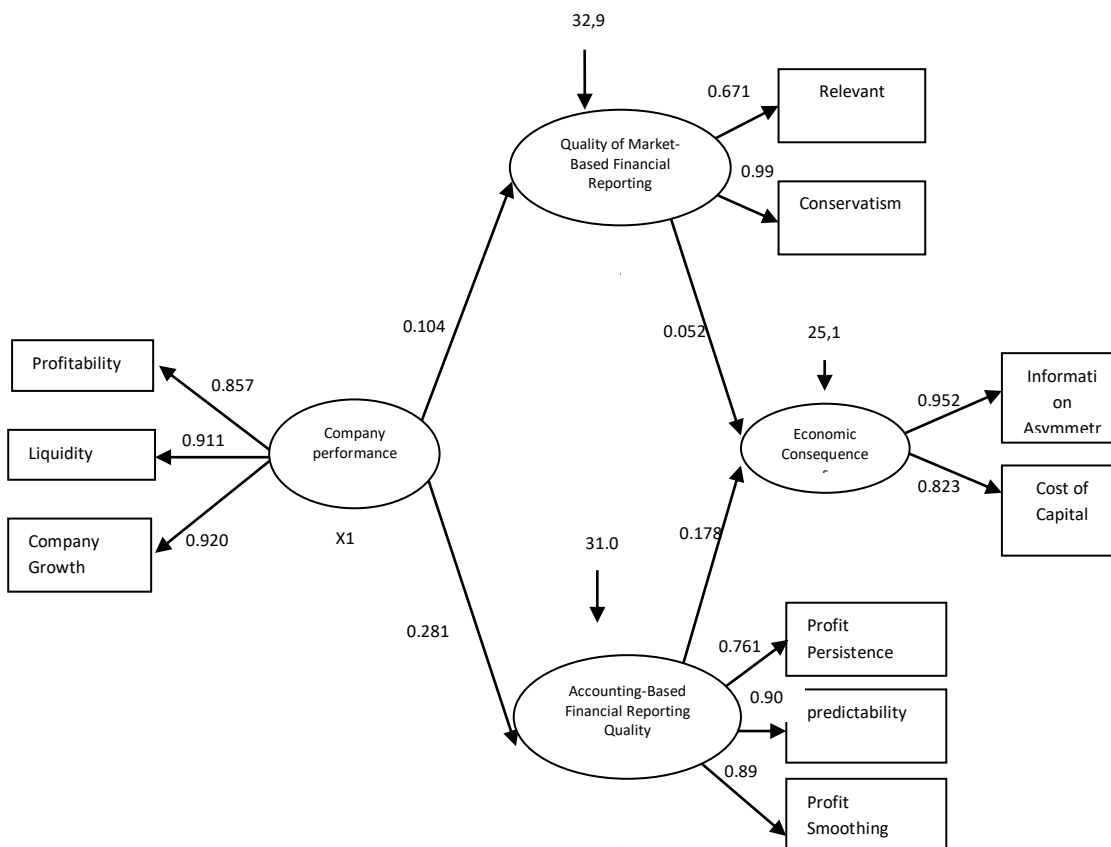
Cost of Equity Capital(Y3.2)	Costs incurred to finance the company's funding sources	shares that occurred in year t $r = (Bt + Xt+1 - Pt) / Pt$ Information : Pt = Share price in period t Bt = Book value per share period t Xt+1=Price per share period t	Ratio
Independent Variable			
Company Performance (X)	The level of achievement or results in order to realize the company's goals		
Profitability (X1)	The company's ability to generate profits proxied by Return on assets.	ROA = Earning After Tax X 100% Total assets	Ratio
Liquidity (X2)	The ability of a company to meet its obligations in the short term	Current Ratio = Current assets x 100 % Current liabilities	Ratio
Company Growth (X3)	The company's growth is measured by changes in total assets, denoted by Growth, namely the ratio of changes in total assets each period.	$Growth = \frac{TotalAssets(t) - TotalAssets(t - 1)}{TotalAssets(t - 1)} \times 100\%$	Ratio

Analysis of the data used in this study by testing the relationship using a structural equation modeling tool with an alternative partial least square method using SmartPLS software. In this study, researchers used SEM (Structural Equation Model) analysis. SEM (Structural Equation Modeling) is a statistical technique that is able to analyze patterns of relationships between latent constructs and their indicators, latent constructs with each other, as well as direct measurement errors. SEM allows analysis among several

dependent and independent variables directly.

## Analysis and Discussion

Based on the research paradigm describing the structural model, based on the results of data processing, the path coefficient is obtained which is illustrated as follows:



Picture. 1 Research Model

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The processing results show that the variable quality of accounting-based financial reporting with indicators of earnings persistence, predictability and smoothing of profits and the variable quality of market-based financial reporting with

a. Model of Measurement of Latent Variable Characteristics of Financial Performance

timeliness indicators has a loading factor below 0.5, so it is not valid in reflecting its latent variables so it is reduced from the model.

The performance characteristic variable consists of 2 (two) indicators and bobot factor each indicator in reflecting the variable performance characteristics as follows:

Indicator	Loading Factor	R2	tcount
Profitability (X1)	0.857	0.735	15,121
Liquidity (X2)	0.911	0.830	27,195
Company Growth (X3)	0.920	0.847	29,088
Composite reliability (CR) = 0.925			
Average Variance Extracted (AVE) = 0.804			

From the table it can be seen that all factor weight values for each indicator are greater than 0.5 and also the results of the test show that the tcount value is greater than the critical value of 1.96. This data shows that the three indicators are significant in reflecting latent variables performance characteristics.

b. Model of Measurement of Market-Based Financial

Reporting Quality of Latent Variables (Y1)

Market-Based Financial Reporting consists of 3 (three) indicators but in the previous test the timeliness indicator (Y1.2) was invalid then it was reduced from the model so that in the next model the variable quality of market-based financial reporting is only reflected by two indicators namely relevance and conservatism.

Indicator	Loading Factor	R2	tcount
Relevance (Y1.1)	0.671	0.450	5,627
Conservatism (Y1.3)	0.993	0.986	44,487
Composite reliability (CR) = 0.831			
Average Variance Extracted (AVE) = 0.718			

From the table it can be seen that all factor weight values for each indicator are greater than 0.5 and also the results of the test show that the tcount value is greater than the critical value of 1.96. This data shows that both indicators are significant in reflecting latent variables quality market based financial reporting.

c. Model of Measurement of Latent Variable Quality of

Accounting-Based Financial Reporting (Y2)

The quality of accounting-based financial reporting consists of 3 indicators and bobot the factors of each indicator in reflecting the quality variable accounting-based financial reporting as follows.

Indicator	Loading Factor	R2	tcount
Persistence (Y2.1)	0.761	0.579	12,257
Predictability (Y2.2)	0.900	0.810	26,976
Income smoothing (Y2.3)	0.896	0.802	18,293
Composite reliability (CR) = 0.890			
Average Variance Extracted (AVE) = 0.730			

From the table it can be seen that all the weight values of the indicator factors are greater than 0.5 and also the results of the test obtained tcount values are greater than the critical value of 1.96. This data shows that the three indicators are significant in reflecting quality latent variables accounting-based financial reporting.

d. Economic Consequence Latent Variable Measurement Model (Y3)

Economic Consequences consists of 2 (two) indicators and a bobot factor each indicator in reflecting the variable Economic Consequences as follows:

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Indicator	Loading Factor	R2	tcount
Information Asymmetry (Y3.1)	0.952	0.906	80,760
Cost of Equity Capital (Y3.2)	0.823	0.677	8,484
Composite reliability(CR) = 0.883			
Average Variance Extracted(AVE) = 0.791			

From the table it can be seen that all factor weight values for each indicator are greater than 0.5 and also the results of the test show that the tcount value is greater than the critical value of 1.96. This data shows that both indicators are significant in reflecting latent variable economic consequences.

## Conclusions and Suggestions

Based on the results of research on the role of intervening variables in the quality of market-based reporting and accounting on company performance and economic consistency, it can be concluded as follows:

Company performance characteristics profitability, liquidity and company growth have no effect on the quality of market-based financial reporting.

Characteristics of company performance profitability, liquidity and company growth affect the quality of accounting-based financial reporting.

The effect of company performance on economic consequences through the quality of market-based financial reporting and accounting makes a positive contribution to the relationship between company performance and economic consequences.

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