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Factors Affecting Earnings Quality in Companies Listed in Indonesia Stock Exchange

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ABSTRACT

This study aims to analyze the factors affecting the quality of accounting profit which include management ownership, IFRS convergence, and debt covenant. The sample taken was from manufacturing companies listed on the Indonesia Stock Exchange that published audited financial report in the year of 2011-2014. The final data used in this study was as many as 401 data. With multiple linear regression analysis techniques, t-test and F test conducted for hypothesis testing. The conclusion obtained from this research shows that managerial ownership has no significant influence on earnings quality, IFRS convergence has no significant influence on earnings quality, and debt covenant has significant influence on earnings quality.

Keywords: Earnings quality, debt covenant, IFRS Convergence, managerial ownership

INTRODUCTION

Accounting earnings is usually used as one of the indicators of firms' financial performance (Alves, 2012). Managers have the opportunity to manage earnings to attract investors or to get personal gain through bonus sharing. That earnings management affects the quality of earnings. How can investors trust the information provided by the company if the information especially earnings information had been managed by the manager?

Earnings quality can be described as how strong a firm's financial performance provides information for decision-maker

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to make the right decision. Dechow et al. (2010) explained that the higher quality of earnings, the more relevant information about the firm's financial performance to decision-maker provided. Many bankruptcy cases in the world caused by the low quality of earnings. Investors failed to make the right decisions because the information provided did not describe the real conditions of the firms. Firms need to improve corporate governance (Hashim & Devi, 2008).

Many factors affect earnings quality based on the previous study. Researches on managerial ownership and earnings quality still generate different results. Jensen and Meckling (1976) theorized if the level of managerial ownership was high, the firms need lower monitoring by the board since the managers' interests would be closely aligned with the owners'. The higher the level of managerial ownership, the lower the possibility of financial statement fraud done by the management. Managerial ownership in Indonesian company is still low (Fendiani & Tandiono, 2016).

International Financial Reporting Standards (IFRS) is an accounting standard developed by the International Accounting Standards Board (IASB) that provides a common global language for business. One of the important benefits is to improve the comparability and understandability of financial statements, especially the financial statements of multinational corporations.

Another benefit of international accounting standards according to Ball (2006) is that an international accounting standard may open up the possibility of comparing financial statements across countries, increasing transparency in financial reporting, reducing information costs, and suppressing asymmetric information. Moreover, for developing countries, which have not been able to make strong accounting standards, the adoption of international accounting standards may strengthen the competitive ability in the capital market (Peavey & Webster, 1990).

However, the adoption of international accounting standards also has controversial issues, such as in the research of Choi and Meek (2005) which concluded that the adoption of international accounting standards would only be beneficial for multinational corporations, whereas, for smaller companies (for instance Small and Medium Enterprise - SME), the standards would be useless and complicated.

Other studies indicate that a country that is likely to succeed in the adoption of international accounting standards is a State that has strong capital markets with Anglo-American based accounting (Zeghal & Mhedhbi, 2006). Another obstacle to the adoption of international accounting standards is that uniformity in the application of accounting standards is difficult because each company has different goals and strategies, different investment and financing policies and political situations (Ball, 2006). Furthermore, as known as international accounting standards developed in developed countries would be better suited for decision making in developed countries, and would not necessarily be appropriate if applied to decision-making in developing countries. After 2012, the second phase of convergence would be conducted in 2013 which would be effective in 2015. Gradually, IFRS has been implemented following the implementation of the relevant PSAK. Implementation of the principle-based accounting principles enables entities to apply them more closely to each other's characteristics, but on the other hand, judgment and subjectivity play a very important role in the application of this standard both in the selection of accounting policies, methods, estimates and elements - other elements. Subjective judgments are sometimes used to generate desired profits (Lobo & Zhou, 2001).

When the company's debt is relatively low, the managers are less likely to manipulate earnings because the probability of violating a covenant is not high. However, when the company has high debt levels, managers tend to manipulate earnings because the risk of breaching a covenant becomes so high. When the managers try to manipulate earnings, the quality of earnings becomes low (Ghosh & Moon, 2010).

Literature Review

Many firms especially publicly listed firm separate the ownership of the shares and the control. This separation could create conflicts between the owner of the firms or shareholders and the managers. Managers have the motivation to get a bonus, while the owner or shareholder have the motivation to get the dividend. In this regard, shareholders need to control and monitor the manager from unethical behaviour. Controlling and monitoring may incur costs. Fleming et al. (2005) found that agency conflict and the degree of separation between ownership and control had a significant positive relationship.

The agency theory suggests a relationship between the principal (owner) and the agent (manager) concerning corporate management, where the principal is an entity that delegates the authority to manage the company to the agent (management). According to Jensen and Meckling (1976), agency theory explains the contractual relationship between the party delegating a particular decision (principal/owner/shareholder) to the party receiving the delegation (agent/management). Conflict of interest between the owner and the agent may occur because the possibility of the agent acting not in accordance with the interests of the principal, thus triggering agency costs. As an agent, managers are morally responsible for optimizing the principal's profits by obtaining compensation in accordance with the contract. Thus, there are two distinct interests within the enterprise in which each party seeks to attain or maintain the desired level of prosperity.

Profit is the main information presented in the financial statements, so the figures in the financial statements become crucial things that must be observed by users of financial statements. This is because the figures in the financial statements are a function of the policies and accounting methods chosen by the company. Profit is an indicator that can be used to measure the company's operational performance that can affect the value of the company. Information about earnings measures the success or failure of a business in achieving its defined operating objectives. Both creditors and investors, use profits to evaluate management performance, predict earnings power, and predict future earnings. Profit quality is a profit that correctly and accurately describes the operational profitability of the company. Accrual accounting earnings raise the issue of earnings quality, as profit from the accrual accounting process becomes the object of profit engineering (earnings management). Some earnings management techniques may affect earnings reported by management. Earning management practices will result in lower reported earnings quality. Earnings can be said to be of high quality if reported earnings can be used by users to make the best decisions, i.e. investor can use the information to decide to buy or sell the shares of other company, and can be used to explain or predict stock prices and returns.

Managerial Ownership. Some researchers define that managerial ownership is the largest share ownership by company management (Sujoko & Soebiantoro, 2007). Managerial ownership can be defined as the percentage of shares owned by the managers (LaFond & Roychowdhury, 2008). Managerial ownership is a percentage of ownership of the board of directors and board of commissioners of the company's shares. The managerial ownership structure has several roles or functions that can be seen from two perspectives; the agency approach and the asymmetric information approach. The agency approach considers the managerial ownership structure as an instrument or tool to reduce agency conflicts between claims against the company so that the firm increases managerial ownership to align the manager's position with the shareholders so to act following the wishes of shareholders. With an increase in ownership, the percentage will align the manager's position (Jensen & Meckling, 1976). Managers who have portions of shares of the firms have less incentive to manage or manipulate earnings and accounting information. The higher the level of the ownership by managers, the interest gap between managers and shareholders will decrease. Therefore as management ownership increases, the incentives to manage earnings will decrease. The decrease in earnings management will increase earnings quality (Warfield et al., 1995). The level of management ownership can limit earnings management activities so the quality of earnings remains high (Ali et al., 2008).

H1: Managerial ownership affects earnings quality.

IFRS Convergence. International Financial Reporting Standards (IFRS) is a principle-based accounting standard that provides the basic principles of accounting practices. Many countries have fully or partially adopted IFRS. Indonesia is a country that uses IFRS as a reference in the preparation of Financial Accounting Standards (SAK).

Accounting standard can limit the managers to manipulate or manage accounting earnings, but it depends on how well the standards are enforced (Leuz et al., 2003). Previous research has suggested that IFRS convergence improves the quality of earnings as indicated by lower earnings management and increased comparability of accounting earnings (Cai et al., 2012; Manzano & Conesa, 2014).

H2: IFRS convergence affects earnings quality

Debt Covenant. Debt financing is one of the sources of external funding. There are two types of debt financing, private and public debt markets. Private debt markets have concentrated lenders, i.e. banks. Public debt is held by bondholders. The differences between both types of debt financing are the access of information, the ability to monitor borrower, flexibility in resetting contract terms, and the contract renegotiation cost (Bharath et al., 2008). Debt covenant explains how managers deal with debt agreements. The manager in responding to a breach of a debt agreement that becomes due will attempt to avoid it by choosing an accounting policy that benefits him. A debt covenant is an agreement to protect the lender from the actions of the manager against the interests of the creditor, such as excessive dividend payout, or leaving the equity below the prescribed level. Debt can have a positive and negative influence on earnings quality. In the positive side, debt can push the manager to carefully provide private information about the future of the company to lower financing cost. In the negative side or in the condition when companies have high debt, managers tend to use accruals aggressively to manage earnings (Ghosh & Moon, 2010).

H3: Debt covenant affects earnings quality

MATERIALS AND METHODS

The observed population was all manufacturing companies listed on the Indonesia Stock Exchange within 4 years (2011-2014). The sample was selected using a purposive sampling method with the condition that the company must be listed during the study period or had been listed before 2011 and not delisted before end of 2014, and published financial statements during the study period. The final sample size for this study was 401 data. The data was collected from the financial statement of the listed company in 2011 – 2014. The collected data were analyzed using multiple regression analysis with 95% confidence level. Managerial ownership was measured using a dummy variable with values 0 and 1. A value of 0 would be given to the companies that did not have managerial ownership and the value of 1 would be given to the companies that had managerial ownership. IFRS convergence was measured using a dummy variable with values 0 and 1. A value of 0 would be given in 2011 data, i.e. the year before IFRS implementation stage in Indonesia and the value 1 would be given in 2012, 2013 and

2014, i.e. the year of IFRS implementation in Indonesia. Debt covenants were measured using debt to total assets ratio.

$$COV = \frac{Total\ Debt}{Total\ Assets}$$

The dependent variable in this research is earnings quality and measured using cash flow from operation to the total asset.

$$EARN = \frac{Cash\ Flow\ from\ Operation}{Total\ Assets}$$

The research model is:

$$EARN = \beta_0 + \beta_1 MOWN + \beta_2 IFRS + \beta_3 COV + \varepsilon$$

MOWN = managerial ownership
IFRS = IFRS convergence
COV = debt covenant

RESULTS AND DISCUSSIONS

Descriptive Statistics

Descriptive statistics are used to describe data viewed from the mean, median, maximum, minimum. This test is done to make it easier to understand the variables used in the research. The descriptive statistical test results can be seen in Table 1.

Multiple Regression Analysis

The multiple regressions result shows that managerial ownership variable has sig or p-value more than alpha 0.05. Therefore, it indicates that managerial ownership variable has no effect on earnings quality variable. This can happen because in manufacturing companies in Indonesia listed on the Stock Exchange, ownership by management is low, so it can not affect management decisions to make earnings management that can reduce the quality of corporate profits.

Table 1
Descriptive statistics

	Minimum	Maximum	Mean	Std. Deviation
MOWN	0.00	1.00	0.4763	0.50006
IFRS	0.00	1.00	0.7531	0.43174
COV	0.00	4.30	0.5431	0.45430
EARN	-0.17	0.43	0.0663	0.09113

Table 2
Multiple Linear regression

Variables	Estimated Coefficient	t-statistic
Intercept	0.086	7.413***
MOWN	-0.007	-0.727
IFRS	0.009	0.903
COV	-0.044	-4.353***

Note: *** statistical significant at the 5% level

As for the IFRS variable, the multiple regressions result show that IFRS convergence variable has sig or p-value more than alpha 0.05. Therefore, it indicates that the IFRS variable has no effect on earnings quality variable. This can happen because in the early years of IFRS implementation, companies still use a lot of old accounting methods (US GAAP) that are also allowed in IFRS. Companies definitely consider the cost and benefits before deciding to change the method.

Based on the multiple regressions result, debt covenant variable has a significant coefficient value of -0.044 because the sig or p-value is less than alpha 0.05. It indicates that a debt covenant has a negative effect on earnings quality. The higher the company's debt, the lower the earnings quality of the company generated. This can happen because companies with high debt will tend to make earnings management to still look attractive by investors and other stakeholders. That earnings management activity makes the earnings quality becomes lower.

F-test examines the effect of management ownership, IFRS convergence, and debt covenant simultaneously to earnings quality. In this research, the F-test result shows that F value is 6,546, while F table is 3.87 for total sample 401 and 5% significance. Therefore, it can be concluded that the independent variables in this study significantly affect the dependent variable simultaneously because of the value of F arithmetic greater than F table.

CONCLUSIONS

The purpose of this study was to determine the effect of management ownership, IFRS convergence, and debt covenant on earnings quality. Based on the results of the study, it can be concluded that management ownership does not affect the quality of earnings because the number of shares owned by management is so small that it cannot affect management decisions to make earnings management. IFRS convergence also does not affect earnings quality in the early years of implementation due to cost and benefit considerations. Debt covenant negatively affects the quality of earnings because the companies will find a way to keep its financial statements attractive if they have high debt, thus allowing the occurrence of earnings management resulting in decreased earnings quality.

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