Firm Characteristics and Financial Reporting Quality: A Case of Property and Real Estate Companies listed in Indonesian Stock Exchange

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Abstract

Objective – This study aims to investigate the impact of firm characteristics, namely leverage, profitability, and firm size, on financial reporting quality as measured by discretionary accruals.

Design/methodology – This sample of this study is Property and Real Estate companies listed in the Indonesian Stock Exchange (IDX) for the period of 2015 to 2017. In total, there are 36 firms chosen as the samples for this study or 108 observations. The data was analyzed using the multiple regression method.

Results – This study demonstrates that the leverage and profitability have significant impact on financial reporting quality, while firm size has no significant impact on financial reporting quality.

Keywords: Financial Reporting Quality, Firm Characteristics, Firm Size, Leverage, Profitability.

1. Introduction

Financial reporting can be defined as process of reporting financial activities of a business in a formal manner (Gaynor, Andrea, Molly, & Teri, 2016). A financial reporting should have good quality, therefore users of the information will not be misled. Thus, financial reporting quality can be defined as the accuracy of financial reporting in conveying information related to a firm’s operational activities (Verdi, 2006).

Several studies have been conducted to examine factors that can affect financial reporting quality, including firm characteristics, such as leverage (Echobu, Okika, & Mailafia, 2017; Hassan & Bello, 2013), profitability (Hassan & Bello, 2013), and firm size (Hassan & Bello, 2013). Leverage is one of the firm characteristics that is believed can affect financial reporting quality. Leverage can be used to measure to what extent the firm’s assets were financed with debt (Kasmir, 2013). Although Olowokure, Tanko, & Nyor (2016) found that leverage has no significant impact on financial reporting quality, (Echobu et al., 2017; Hassan & Bello, 2013). But, Mahboub (2017) found that leverage have positive and significant impact on financial reporting quality. These results might be the outcome of close supervision by providers of funding sources to safeguard their funds, thereby encouraging managers to present high-quality financial reporting (Echobu et al., 2017).

Profitability is the second firm characteristics that is believed can affect financial reporting quality. Profitability explains the firm’s ability to earn profits in a certain period (Hermuningsih, 2012). Mahboub (2017) found that profitability has no significant impact on financial reporting quality, however Hassan & Bello (2013) found that profitability have positive and significant impact on financial reporting quality. These might happen because firms that earn more profit tend to disclose more information to improve financial reporting quality, to distinguish them from firms with worse performance.

Moreover, firm size is might affect financial reporting quality. Firm size shows the
size of the wealth (assets) owned by a firm (Susanto & Ramadhani, 2016). Olowokure et al., (2016) found that firm size has no significant impact on financial reporting quality, but Hassan & Bello (2013) found that firm size has positive and significant impact on financial reporting quality. These results indicate that larger firms tend to have a good internal control system and able to obtain high-quality audit services form large public accounting firms that are expected to improve their financial reporting quality, and they care for their reputation by presenting high-quality financial reporting (Hassan & Bello, 2013).

Previous studies show different results regarding the impact of firm characteristics, such as leverage, profitability, and firm size on financial reporting quality. These differences might occur due to differences of research objects, or years of observation period. At instance, the result from previous studies done by Olowokure et al., (2016) regarding the impact of firm size on financial reporting quality shows different results from studies done by (Echobu et al., 2017; Hassan & Bello, 2013; Mahboub, 2017), although Mahboub (2017) and Olowokure et al., (2016) have the same research object, which is bank industry, the differences might have happened because Olowokure et al., (2016) observation period was 10 (ten) years, whereas Mahboub (2017) observation period was only 4 (four) years. The difference results regarding the impact of profitability on financial reporting quality might also happened due to differences in research object, Mahboub (2017) conducted his studies on Bank in Lebanon for the period of 2012-2015, while Hassan & Bello (2013) conducted their studies on listed manufacture firms on Nigerian Stock Exchange (NSE) for the period of 2006-2010. On the other hand, both studies of Hassan & Bello (2013) and Olowokure et al., (2016) show different results regarding the impact of firm size on financial reporting quality were conducted on listed firms on NSE, however Hassan & Bello (2013) conducted their studies on manufacture industry, while Olowokure et al., (2016) conducted their studies on bank industry.

Based on the above discusses previous studies, this study investigates the impact of leverage, profitability, and firm size on financial reporting quality of listed Property and Real Estate firms on Indonesia Stock Exchange (IDX) for the period of 2015-2017. The Property and Real Estate firms were chosen because of, according to the Indonesian Bank Central (Bank Indonesia), their impact on Indonesia national economic development (Sandy, 2017). Senior Deputy Governor of BI also explained that property sector is one of the sector that is capable of absorbing large numbers of workers, and has significant chain effect to other economic sectors. Thus, this sector has significant affect to improve the development of other economic sectors.

The next section of this study will explain the literature reviews, conceptual framework, and hypothesis development. Then the following section will discuss research methods, results and discussions, followed by conclusions, limitations, and suggestions for further studies.

2. Literature Review and Hypothesis Development

Agency Theory

In the agency theory, there are two involved parties of a corporation, namely principal and agent (Jensen & Meckling, 1976). The owner of the firm as principal gives trust (formally in the form of contract of employment) to the management as agent who provides managerial services. In this case the agency problem is reflected by the presence of information asymmetry between principal and agent. The agent has more information regarding the firm compared to principal, therefore agents will be able to affect the process of financial reporting to maximize their interests.

The outputs of financial reporting are consider as the firm’s communication tool to stakeholders, which was determined by financial policies implemented by manage-
ment. One of the issues that will reduce the financial reporting quality is earnings management. Healy & Wahlen (1999) revealed that earnings management happened when managers use considerations in arranging transactions and reporting financial activities to transform the financial statements that will misled stakeholders regarding the firm’s economic basis, or to influence contractual outcomes that depend on reported accounting numbers.

Each individual is assumed to be motivated solely by their own interests, causing a conflict of interest between principal and agent. Principal is motivated to increase his wealth with increasing profitability, while agent is motivated to maximize the fulfillment of his economic and psychological needs in terms of obtaining investments, loans, and compensation contracts.

Based on agency theory, differences in interest between principal and agent will caused conflicts that are commonly called as “agency conflict”. In Kholmi (2010), Scott (1997) explained that the essence of agency theory is the appropriate contract design to align principal and agent interests in the case of conflict of interest occur. Therefore, in agency theory, corporate governance must monitor and control management to ensure that they followed the rules and regulations. Agency theory considers the role of corporate governance mechanisms to reduce agency conflict between principal and agent (Healy & Wahlen, 1999).

**Financial Reporting Quality**

Financial reporting is not only a final output, the quality of this process depends on each part, including the selection of information, firm’s transactions disclosure, and application of accounting policies and knowledge of the judgments made. Financial information issued by a firm has become an essential source for any market participant, since it will reduced the information asymmetries between managers, investors, society, regulatory agencies, and other stakeholders (Jonas & Blanchet, 2000; Martínez-Ferrero, García-Sanchez, & Cuadrado-Ballesteros, 2013). The main purpose of financial reporting is to provide high-quality accounting information regarding firm activities that are useful in making decisions (IASB, 2008). Therefore, financial reporting quality can be defined as the process of financial reporting provides fair and transparent information regarding firm’s performance and financial positions (Tang et al., 2018). Financial reporting quality requires firms to voluntarily expand the scope and quality of reported information to make sure that market participants are thoroughly informed in order to make well-grounded decisions on investment, credit, etc.

In previous studies, the most widely used proxies to measure financial reporting quality were earnings quality, accounting conservatism, and accrual quality (Martínez-Ferrero et al., 2013). It is necessary to reckon that earnings quality is negatively associated with earnings management, which is considered to be the inverse of financial reporting quality (Dechow & Dichev, 2002), a higher degree of earnings management is associated with lower financial reporting quality (Martínez-Ferrero et al., 2013). The second measure for financial reporting quality is the degree of accounting conservatism. Conservative accounting reflects bad news for the firm more rapidly than good news since this approach tends to reduce litigation risks (Basu, 1997). Other measure of financial reporting quality that has been used in previous studies is the accrual quality. Accrual quality is measured through the (Ball & Shivakumar, 2005). The model proposed by Ball & Shivakumar (2005) to obtain other measurement of accrual quality suggests that nonlinear accrual models that incorporate the timely recognition of losses perform better than linear models.

This study uses earnings management as the proxy for financial reporting quality, as in (Aderemi, Osarumwense, Kehide, & Egibde, 2016; Bajra & Cadez, 2018). There are two accrual concepts in earnings management, namely non-discretionary accruals and discretionary accruals. Non-discretionary accruals are the recognition of reasonable earnings accruals, which are subject to generally accepted accounting standards or principles, while discretionary accruals are the recognition of earnings accruals, that are not
subject to any regulations and are the choices of management policies in selecting the accounting methods (Kusumaningtyas & Farida, 2015). The discretionary accrual is a way to change earnings reported that is difficult to detect through manipulation of accounting policies related to accruals. The main advantage of using discretionary accruals to measure earnings management, is that the information are available in annual reports (Beest, Braam, & Boelens, 2009).

Conceptual Framework

Based on the purpose, theories, and previous studies, conceptual framework for this study is as follows:

Impact of Leverage on Financial Reporting Quality

Any firm’s motives are to earn profit, and maximize the owner’s wealth, therefore to achieve these motives, firms need sources of funds. Whether large or small firms need funds to support their operational, specifically large firms need funds to expand their operational and activities. Firms must choose the best financing source to achieve an optimal capital structure, therefore they will be able to make appropriate financing decisions that will enable them to achieve positive results (Adenugba, Ige, & Kesinro, 2016)

Higher the leverage, creditor has greater right to supervise and be aware of their operational activities since creditor concerned to secure their funds (Susanto & Ramadhani, 2016). In Darwis (2009), Jensen & Meckling (1976) that agency theory predicted that firms with higher leverage ratio will disclose more information since they have higher agency costs. Better quality of financial reporting quality is expected with broader disclosure of information. Olowokure et al., (2016) found that leverage has no significant impact on financial reporting quality, while Hassan & Bello (2013) and Mahboub (2017) found that leverage has positive and significant impact on financial reporting quality. Therefore, the first hypothesis for this study is as follows:

H1: Leverage has significant impact on financial reporting quality.

Impact of Profitability on Financial Reporting Quality

Profitability is the main benchmark of the overall success of a firm. In (Hermuningsih, 2012), Husnan (2001) stated that profitability is the ability of a firm to earn profits at a certain level of sales, assets, and share capital. According to (Dioha, Ahmed, & Okpanachi, 2018), profitability can be described as measure of how well a firm uses its assets in earning profits. Profitability is a significant aspect to maintain its long-term sustainability, since profitability shows whether a firm has good prospects in the future. Consequently, every firm will always try to increase their profitability, since the higher the level of profitability of a firm, the sustainability of a firm will be more guaranteed (Hermuningsih, 2012).
Theoretically, a firm that exhibits loss is likely to do accounting manipulations to present better figures (Hassan & Bello, 2013). If agent carries out this opportunistic action, it will reduce the quality of financial reporting. Mahboub (2017) found that profitability has no significant impact on financial reporting quality, whereas Hassan & Bello (2013) found that profitability has positive and significant impact on financial reporting quality. Thus, the second hypothesis in this study is as follows: 

H2: Profitability has significant impact on financial reporting quality.

**Impact of Firm Size on Financial Reporting Quality**

Firm size is a scale that shows the size of a firm (Putranto & Darmawan, 2018; Rochimawati, 2012). Small firms are considered to do more earnings management practices, seeing that smaller firms tend to desire to show the condition of firm that is always performing well so that investors will get attracted to invest in their firms. In contrast to small firms, large firms tend to be more attentive in financial reporting since they are more concerned by the public (Medyawati & Dayanti, 2016).

Agency theory also expressed that with the aim of reducing agency costs, large firms tend to disclose broader information. This is because large firms tend to have greater agency costs (Darwis, 2009). With broader disclosure if information, the quality of financial reporting is expected to be better, so users of financial statement which is one of the output of financial reporting, will not be disadvantaged. Although Olowokure et al., (2016) found that firm size has no significant impact on financial reporting quality, but Hassan & Bello (2013) found that firm size has positive and significant impact on financial reporting quality. Subsequently, the third hypothesis of this study is as follows:

H3: Firm size has significant impact on financial reporting quality.

### 3. Research Method

#### Sample and Data

Population of this study is listed Property and Real Estate firms, therefore the sample of this study is listed Property and Real Estate firms in Indonesia Stock Exchange (IDX), that published their annual reports on their websites, or their annual reports are available at www.idx.co.id, for the period of 2015 to 2017. Consequently the sample obtained for this study is 36 firms, hence the total observation for this study is 108. This study used secondary data as book, media, published journals, and audited and published annual reports.

#### Operational Variables

**Financial Reporting Quality**

In this study, financial reporting quality is measured by discretionary accruals as (Aderemi et al., 2016; Prasasti & Ardianto, 2011). Before measuring the discretionary accruals, total accruals and non-discretionary accruals need to be measured beforehand. Total accruals can be measured as follows:

\[
TA_{it} = NI_{it} - OCF_{it} \quad (1)
\]

Total accruals (TA_{it}) above will be used to estimate the regression as follows:

\[
\frac{(TA_{it}/A_{it-1})}{\alpha_1(1/A_{it-1}) + \alpha_2(ΔREV_{it}/A_{it-1}) + \alpha_3(PPE_{it}/A_{it-1}) + e_{it}} \quad (2)
\]

After getting the coefficient regression from above formula, non-discretionary accrual (NDA) will be measured as follows:

\[
NDA_{it} = \alpha_1(1/A_{it-1}) + \alpha_2((ΔREV_{it} - ΔREC_{it})/A_{it-1}) + \alpha_3(PPE_{it}/A_{it-1}) \quad (3)
\]

Subsequently, discretionary accrual (DA) can be measured using the formula below:
\[ DAit = \frac{TAit}{Ait-1} - NDAit \] (4)

**Descriptions:**
- \( TAit \): Total accrual firm \( i \) on period \( t \)
- \( NIit \): Net income firm \( i \) on period \( t \)
- \( OCFit \): Operational cash flow firm \( i \) on period \( t \)
- \( Ait-1 \): Total asset firm \( i \) on period \( t-1 \)
- \( \Delta REVit \): Change of revenues firm \( i \) from period \( t-1 \) to period \( t \)
- \( PPEit \): Property, plant and equipment firm \( i \) on period \( t \)
- \( NDAit \): Non-discretionary accrual firm \( i \) on period \( t \)
- \( \Delta REC it \): Change of receivables firm \( i \) from period \( t-1 \) to period \( t \)
- \( DAit \): Discretionary accrual firm \( i \) on period \( t \)

**Leverage**
Leverage was measured by debt ratio. Debt ratio is used to measure the ratio of total liability and total asset. This measurement is used by (Echobu et al., 2017; Mahboub, 2017).

**Profitability**
In this study, profitability was measured by ratio of return on equity (Lestari & Wulandari, 2019). Return on equity is used to measure the ratio of total net income and total equity.

**Firm Size**
Measurement of firm size is the logarithm of total assets owned by the firm, as (Mahboub, 2017).

**Method Analysis**
Method analysis that used in this study is multiple regression analysis. The regression model to test the hypothesis in this study is as follows:

\[ Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon \]

**Descriptions:**
- \( Y \): Financial reporting quality
- \( \alpha \): Constants
- \( \beta_1, \beta_2, \beta_3 \): Regression coefficients of each independent variables
- \( X_1 \): Leverage
- \( X_2 \): Profitability
- \( X_3 \): Firm size
- \( \varepsilon \): Epsilon (error term)

**4. Result and Discussion**

**Descriptive Statistics**
Descriptive statistics describes brief summary of all variables used in this research. Descriptive statistics for this study can be seen at table 1.

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>DACC</td>
<td>108</td>
<td>-.11</td>
<td>.31</td>
<td>.0435</td>
<td>.07696</td>
</tr>
<tr>
<td>LEV</td>
<td>108</td>
<td>.03</td>
<td>.72</td>
<td>.3762</td>
<td>.18156</td>
</tr>
<tr>
<td>ROE</td>
<td>108</td>
<td>-.15</td>
<td>.41</td>
<td>.0691</td>
<td>.09069</td>
</tr>
<tr>
<td>FSIZE</td>
<td>108</td>
<td>10.90</td>
<td>13.75</td>
<td>12.6886</td>
<td>.61196</td>
</tr>
</tbody>
</table>

Source: SPSS
Minimum value of discretionary accrual in negative state shows that this firm has the highest degree of financial reporting quality. Minimum value of leverage is 0.03 shows that at least 3% assets owned by the firm was financed with debt, while mean value of leverage is 0.3762 shows that 37.62% assets owned by most firms were financed with debt. Consequently, profitability that was measured with ROE is in negative state which means the firm was not capable to earn profit for that period, while the mean value of ROE IS 0.0691 means that most firms able to earn profit at least 6.91% in deploying the shareholders’ capital. Minimum value of firm size is 10.9 which is the logarithm of total assets, this shows that the minimum total assets owned by the firm in this study worth 80,234 (in millions of Rupiah), while the maximum value of firm size in this study has total assets worth 56,772,116 (in millions of Rupiah).

Classical Assumption Tests

Classical assumption test are required to be performed before using multiple regression analysis. Regression model of this study has passed normality test, heteroscedasticity test, autocorrelation test, and multicollinearity test, thus the results can be interpreted efficiently and accurately. Therefore, data in this study have met all the classical assumption tests to be able to continue the regression test.

Multiple Regression Analysis

If p value < 0.05, the Ho is rejected and Ha will not be rejected, which means independent variable has significant impact on dependent variable. Table 2 shows the result of hypotheses test in this study.

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>0.209</td>
<td>1.384</td>
<td>0.169</td>
</tr>
<tr>
<td>LEV</td>
<td>0.089</td>
<td>2.160</td>
<td>0.033</td>
</tr>
<tr>
<td>ROA</td>
<td>0.445</td>
<td>6.022</td>
<td>0.000</td>
</tr>
<tr>
<td>FSIZE</td>
<td>-0.018</td>
<td>-1.441</td>
<td>0.153</td>
</tr>
</tbody>
</table>

Table 2. Summary of the Results of Regression Test

Hypothesis 1 stated that the leverage has significant impact on financial reporting quality. Based on output presented in Table 2, it shows that the coefficient value = 0.089, and significant at P = 0.033. Thus it can be concluded that leverage has significant impact on financial reporting quality, hence the first hypothesis is not rejected.

Hypothesis 2 stated that the profitability has significant impact on financial reporting quality. Based on output presented in Table 2, it shows that the coefficient value = 0.445, and significant at P = 0.000. Thus it can be concluded that profitability has significant impact on financial reporting quality, hence the second hypotheses is not rejected.

Hypothesis 3 stated that ‘Firm size has significant impact on financial reporting quality”. Based on output presented in Table 2, it shows that the value is not significant at P = 0.153. Thus it can be concluded that firm size has no significant impact on financial reporting quality, hence the third hypothesis is rejected.

Coefficient of determination (R2) presented in Table 2 is 0.273, which means that the independent variables in this study are able to explain their contribution in influencing financial reporting quality by 27.3%, the remaining 72.7% are influenced by other variables not included in this study.
Impact of Leverage on Financial Reporting Quality

Result shown positive and significant impact means that leverage has a positive impact on increasing discretionary accruals which is the proxy of financial reporting quality. Increasing discretionary accrual indicates that there is an increase in earnings management, thus the greater value of discretionary accruals indicates that the firm has low-quality of financial reporting (Prasasti & Ardianto, 2011). Therefore it can be concluded that the result of this study indicate that the greater value of leverage, the lower the quality of financial reporting. The result of this study is in line with Echobu et al., (2017) who also found that leverage has positive and significant impact on discretionary accruals for the measurement of financial reporting quality.

Impact of Profitability on Financial Reporting Quality

Result shown positive and significant impact means that profitability has a positive impact on increasing discretionary accruals which is the proxy of financial reporting quality. Thus can be concluded that the greater value of ROE which is the proxy of profitability, the lower the quality of financial reporting. This result is in line with the findings of Agrawal & Chatterjee (2015) who also found that profitability has positive and significant impact on discretionary accruals. This result indicates that firms that earns higher profits are interested in involving earnings management to achieved the desired level of profit in ensuring that investors will not lost their trust to the firm.

Impact of Firm Size on Financial Reporting Quality

Result shown that firm size has no significant impact on financial reporting quality. This is not in line with previous studies who found firm size has significant impact on discretionary accrual (Amertha, Ulupui, & Putri, 2014). However this study is in line with Olowokure et al., (2016) and Mahboub (2017) who also found that firm size has no significant impact on financial reporting quality.

5. Conclusions, Limitations, and Suggestions

This study aims to examine the impact of firm characteristics, namely leverage, profitability, and firm size on financial reporting quality measured by discretionary accruals. The results showed that leverage and profitability have positive and significant impact on financial reporting quality, whereas firm size has no significant impact on financial reporting quality.

This study also had limitations, specifically this study was only conducted on listed Property and Real Estate firms on IDX as the research objects, and the observation period was only 3 (three) years. Thus, this study can provide suggestions for further research to expand the research subject, and observe different time periods, to enable the emergence of different results and conclusions. Other variables that might affect financial reporting quality should also be added, such as liquidity, ownership structure, or audit quality.

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