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THE EFFECT OF GOOD CORPORATE GOVERNANCE MECHANISM, AUDIT QUALITY, FIRM CHARACTERISTICS, AND INFORMATION ASYMMETRY ON FINANCIAL REPORTING QUALITY

(Empirical Study: Consumer Goods Industry Sector Companies listed on the Indonesia Stock Exchange in 2014-2016)

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ABSTRACT

This study aims to examine the influence of good corporate governance mechanisms, audit quality, firm characteristics, and information asymmetry on financial reporting quality. This study was causal study with the population of consumer goods industry sector listed on the Indonesia Stock Exchange for the period 2014-2016. PLS was used as an analytical tool in this study. The research data used comes from financial reports collected by downloading on the official website of Indonesia Stock Exchange. The results of the research show that good corporate governance mechanisms and audit quality has no a significant effect on financial reporting quality. Firm characteristics and information asymmetry has significant effect on financial reporting quality

KEYWORDS: *good corporate governance mechanisms, audit quality, firm characteristics, information asymmetry, financial reporting quality*

PRELIMINARY

Definition of financial statements in theFinancial Accounting Standards according to theInstitute of Indonesia Chartered Accountants (2015: 1): "Financial reports are a structured presentation of financial position and financial performance of an entity". Based on the Basic Framework for Preparation and Presentation of Financial Statements (KDPPLK), the purpose of financial statements is to provide information relating to financial position, performance, and changes in the financial position of an entity that benefits users in economic decision making. The financial statements also show what has been done by management (stewardship), or management's responsibility for the resources entrusted to management. Institute of Indonesia Chartered Accountants (2015:3)

Accounting information can be called quality if it produces information that is useful for the decision making of investors and other parties. For information in the financial statements to be useful to users, the information presented in the financial statements must meet qualitative characteristics. Qualitative characteristics are intended to provide basic criteria in choosing alternative methods of accounting and financial reporting as well as disclosure requirements.

As for Institute of Indonesia Chartered Accountants, in KDPPLK paragraph 24 defines qualitative characteristics as a characteristic that makes information in financial statements useful for users. There are four basic qualitative characteristics, namely: understandable, relevant, reliable, and comparable.

In general, financial reporting that meets these qualitative characteristics is financial reporting that is of high quality or capable of producing financial information that meets the desires of users (Jonas and Blanchet, 2000). However, in reality, many financial reporting practices do not meet these characteristics. Many financial reporting practices deviate from the standards applied. This practice occurs both abroad and within the country. Yadiati and Mubarok (2017: 2)

Furthermore, the Financial Services Authority requires all issuers and public companies to improve the quality of annual reports. This will be contained in the Financial Services Authority Regulation (POJK) concerning the Annual Report of Issuers or Public Companies and OJK Circular concerning the Form and Content of the Annual Report of Issuers or Public Companies. (sumber: www.market.bisnis.com).

Factors that will influence financial reporting quality, including the mechanism of good corporate governance. The mechanism of supervision and implementation of good corporate governance can ensure the reliability and integrity of financial statements. One important role of corporate governance is ensuring financial reporting quality (Cohen, *et al.,* 2004). Through the implementation of effective corporate governance, there will be clarity of roles and relationships between various internal functions of the company, which if implemented effectively will improve the quality of financial reporting. Klai and Omri (2011) conduct research on Corporate Governance and Financial Reporting Quality: The Case of Tunisian Firms. The results of the study stated overall, researchers found that governance mechanisms had a significant influence on the quality of financial reporting of Tunisian companies.

Furthermore, audit quality affects financial reporting quality. According to Arens *et al.* (2011: 105), audit quality is an audit process to detect and report misstatement material in financial statements. The aspect of detection reflects the auditor's ability to demonstrate audit ethics and integrity, especially independence. Users certainly expect that financial reports audited by independent auditors can be used as a basis for decision making. Two important concepts in realizing auditor quality, namely competence and independence.

The next factor that influence financial reporting quality is firm characteristics, Shehu(2012) define the firm characteristics are those incentive variables that relatively sticky at firms level across time).Yadiati dan Mubarok (2017:126).Another factor is information asymmetry.Huda and Naution (2014: 136) states that Irfan (2002), defines information asymmetry is a condition where there is an imbalance in information acquisition between management as the party giving information to the shareholders and stakeholders who are generally users of information.

LITERATURE, FRAMEWORK, AND HYPOTHESES

Literature

Walras Theory (Input - Output Theory)

In the period 1930-1950, the development of applied general equilibrium models developed rapidly, such as the Leontief (1930s) input-output (I-O) model, and the Social Accounting Matrix(SAM) model. In the period after the 1950s supporting data for the applied general balance model (such as I-O and SAM) can be used as a support for the theoretical general balance model (Hulu, 1995). (Susilo, 1999). Financial statements are outputs or the results of a series of recording processes that begin with inputs, namely transactions.

Stakeholder Theory

Deegan (2004) states based on stakeholdertheory, organizational management expected tocarry out activities that considered important by stakeholders and report activities to stakeholders.

Tandiontong (2016:1) states Freeman (1984)defines stakeholders as groups or individuals who can influence and or be influenced by the achievement of certain goals.

Signalling Theory

Rura (2010:384) states that the signallingtheory introduced by Akerlof (1970), namely information has value, and in a transaction, the parties involved have different levels of information. Signalling theory emphasizes the importance of information released by companies on investment decisions of parties outside the company.

The impact of good corporate governance mechanism on financial reporting quality

According to Sulistyanto (2018: 134), good corporate governance defined as a system that regulates and controls the company to creates value added for all its stakeholders. For this reason, there are two things emphasized in this concept, namely the rights of shareholders that must be fulfilled by the company and the obligations that must be carried out by the company.

One of the important roles of corporate governance is ensuring financial reporting quality (Cohen *et al.*, 2004). Through the implementation of effective corporate governance there will be clarity of roles and relationships between various internal functions of the company, which if implemented effectively will improve the quality of financial reporting

One effort to create financial reporting quality and realize a healthy and responsible business is building a more effective system of supervision and control. An effective system of supervision and control will hinder management from hiding, changing, and delaying information that the public should know.

The results of the study by Iswara (2016) show that corporate governance have a significant effect on the quality of financial reporting. The independent commissioners can create control over management actions. The results of the iswara research (2016) are supported by Tua (2015) and Fathi (2013)

H_1: Good corporate governance mechanism has a significant effect on financial reporting quality

The impact of audit quality on financial reporting quality

Djanegara (2017) researches the influence of audit quality on the quality of local government financial reports. The results of the study stated that audit quality has a positive effect on the quality of financial statements. Defond, & Zhang (2014: 275) argue that the higher audit quality make the quality of financial statements become higher, because audit quality will improve the credibility of financial statements, in line with the opinion of Deloitte (2015: 54-55) that "Audit findings help improve the financial statements to enable full compliance with IPSAS ". Djanegara (2017)

H_2: Audit quality has a significant effect on financial reporting quality

The impact of firm characteristics on financial reporting quality

Based on stakeholder theory, companies willtry to disclose mandatory information so that stakeholders continue to place trust in the company, one of which is quality financial statement disclosure, the existence of company characteristics, namely performance variables and structural variables are expected to improve financial reporting quality.

The research results of Raharjo (2017)concluded that monitoring variables and performance were proven to affect the quality of financial reporting. This finding indicates that the monitoring and performance variables are factors considered by management in carrying out the process of preparing financial statements.

H3: Firm characteristics has a significant effect on financial reporting quality

The impact of information asymmetry on financial reporting quality

Huda and Naution (2014: 136) states that Irfan (2002), defines information asymmetry is a condition where imbalance in information acquisition between management as the part giving information to the shareholders and stakeholders

In the study of Dhaneswari and Widuri (2013), information asymmetry proxied on the bid-ask spread and obtaining the results of information asymmetry has a positive and significant effect on increasing profits on earnings management, so it can be interpreted that if there is high information asymmetry it will affect the increase in profit management.

RESEARCH DESIGN AND METHOD

The types of research

Based on the analysis approach, this study was classified into quantitative research. Quantitative analysis is carried out by testing hypotheses that have been developed.

Research Population and Samples

The population in this study is the consumer goods industry sector companies listed on the Indonesia Stock Exchange (IDX). The sample selection uses purposive sampling, where the sample used meets the specified criteria. the sample criteria used in this research are:

1. Consumer goods industry sector companies listed on the Indonesia Stock Exchange in 2017;
2. The company publishes audit financial reports for the 2014-2016 period;
3. The company uses rupiah currency in financial statements;
4. The company did not experience losses for the 2014-2016;
5. The company is active and does not stop its activities on the stock market during the research period;
6. The company has all the data needed during the research period

Definition of Variable Operationalization andVariable Measurement Financial Reporting Quality

According to Pura (2013: 11), qualitative characteristics are characteristics that provide useful financial statement information to users. The financial statements produced by a company must provide benefits to those interested in the financial statements.

In the accrual model, financial reporting quality associated with earnings management practices. In this model, it is assumed thatmanagement applies discretionary accruals, where managers have the power to manage earnings. Earnings management has a negative relationship with financial reporting quality because it reduces the usefulness of financial statement information for decision making.

The measurement of earnings management practices uses the McNichols (2002) model. McNichols (2002) model which considers residual standard deviations or error terms as a measure of reporting quality. (Klai and Omri, 2011)

$$\frac{ACCR_{it}}{TA_{it-1}} = \frac{\alpha_0}{TA_{it-1}} + \frac{\alpha_1 CF_{it-1}}{TA_{it-1}} + \frac{\alpha_2 CF_{it}}{TA_{it-1}} + \frac{\alpha_3 CF_{it+1}}{TA_{it-1}} + \frac{\alpha_4 \Delta REV_{it}}{TA_{it-1}} + \frac{\alpha_5 PPE_{it}}{TA_{it-1}} + \varepsilon_{it}$$

Information :

$ACCR_{it}$: total current accrual

CF_{it} : current period operating cash flows,

CF_{it-1} : previous period operating cash flows, CF_{it+1} : next period operating cash flow, Δrev_{it} : income changes, and

PPE_{it} : the level of property, plant, and equipment,

All these variables are scaled by lagged total assets (TA_{it-1}).

Good Corporate Governance Mechanism

The measurement of good corporate governance mechanism is internal mechanism. The internal mechanism is influenced by the company's internal factors which include institutional ownership, managerial ownership, independent commissioners, and audit committee.

The existence of independent commissioners is the proportion of independent commissioners to the number of commissioners from a company.

Managerial ownership variables use a dummy variable to indicate the presence or absence of managerial ownership. Dummy is used with the provisions D = 1 for companies that have managerial ownership and D = 0 for companies that do not have managerial ownership (Dewi, 2008)

Hery (2014: 172) states that institutional ownership describes the level of share ownership by institutions in the company. Measurements are following the measurement formula by Yasmeen and Hermawati (2015), measured in the percentage of the number of shares held by the institution from the total outstanding shares

An audit committee with a sufficient total of members will encourage the supervisory function carried out. POJK No. 55/POJK.04/2015 article 4 states that the Audit Committee consists of at least three members who come from Independent Commissioners and Outside Parties of Issuers or Public Companies.

Audit Quality

Tandiontong (2016:84) states that the measurement of audit quality uses the size of a public accounting firm by De Angelo's statement (1981). Audit quality measurement uses a dummy variable, where if the public accounting firm is an accountant office affiliated with Big 4, PricewaterhouseCooper (PwC), Delloite Tohce Tomatsu Limited, Ernst & Young (EY) and KPMG, will be given a value of 1 and 0 for non- Big 4.

Audit quality can guarantee the quality of the company's financial statements. Big four KAPs are better able to maintain their independence so they can produce good financial reports

Firm Characteristics

Yadiati dan Mubarok (2017:126) stated Lang and Lundholm (1993) divided company characteristics into three categories, namely performance variables, structural variables, and offer variables. In this study measurement of company characteristics in terms of performance variables and structural variables

Performance variables are related to a specific time period or can change from time to time and represent an interesting information to be disclosed and at the same time become a consideration for users of financial statements (Lang dan Lundohm, 1993; Wallance *et al.*, 1994; Naser,1998; Al Saeed, 2006; Naser *et al.*, 2002). Performance variables are measured by :

1. Liquidity Ratio

Prihadi (2017: 177). current ratio is a ratio used to measure a company's ability to pay short-term liabilities using current assets.

$$Current\ ratio = \frac{Current\ Asset}{Current\ Liabilities} x\ 100\%$$

2. Profitability

According to Kasmir (2014: 115), the definition of profitability ratios is a ratio to assess a company's ability to seek profits. Profitability is measured by ROE and Profit Margin, along with the calculation formula:

Return on equity (ROE):

$$Return\ on\ equity\ (ROE) = \frac{Earnings\ After\ Tax}{Total\ Equity} x\ 100\%$$

Profit Margin

$$Net\ Profit\ Margin = \frac{Net\ Income}{Sales} x\ 100\%$$

Structural variables that are characteristic of a company that is known to be relatively stable for some time (Lang dan Lundohm, 1993 dan Wallance *et al.*, 1994). Structural variables are measured by :

Leverage

According to Hartono (2018: 13) Debt to Asset Ratio is a ratio that measures the part of assets used to guarantee overall liabilities

$$Total\ Debt\ to\ Asset\ Ratio = \frac{Total\ Debt}{Total\ Asset} x\ 100\%$$

Information Asymmetry

Measurements of information asymmetry are often proxied by the bid-ask spread because information asymmetry cannot be directly observed. SPREAD= $(Ask_{it} - Bid_{it}) / (Ask_{it}+Bid_{it})/2)\}x\ 100$

Information :

SPREAD =

Ask_{it} = The price ask for the highest share of the company i that occurs on the day t

Bid_{it} = The lowest bid price of company I shares that occur on day t

RESULTS AND DISCUSSION

Descriptive Statistics

According to Ghozali (2015), descriptive statistics provide an overview or description of a data seen from the average value (mean), standard deviation, maximum and minimum variants.

Measurement Model (Outer Model)

Convergent Validity

The results of the convergent validity test after the respecification process state that the variable has a loading factor > 0.50, so it can be concluded that all indicators of the latent construct are valid and already compiled the convergent validity requirements

Discriminant Validity

The result of discriminant validity states the loading factor value of indicator for each latent variable has good discriminant validity where some latent variables do not have a measure that correlates highly with other constructs.

The next discriminant validity test uses the value of AVE (Average Variance Extracted) and it can be concluded that all constructs meet the discriminant validity requirements namely the value of AVE above 0.50

Composite Reliability

Construct are declared reliable if the composite reliability value is above 0.70. This study assessed the reliability of constructs using criteria from composite reliability. The composite reliability test results are above 0.70 so it can be concluded that all constructs meet the criteria of reliability and meet the reliability test

Structural Model (Inner Model) R-Square

The results of the R-Square are 0.499 so it can be concluded that the constructed variable of financial reporting quality which proxied by earnings management can be explained by construct variables of good corporate governance mechanism, audit quality, firm characteristics, and information asymmetry about 49.90% while 50.10% explained by other variables apart from those studied and it can be concluded the endogenous latent variables in structural models indicate moderate

Estimate for Path Coefficient

Estimate for Path Coefficient is the path coefficient value and the magnitude of the relationship / influence of the latent construct and tested using the bootstrapping procedure.

Tests for significance were carried out by testing the one-tailed t-test. t-test having a threshold of 1.28 (for a significant level of 10%), 1.65 (5%), 2.33 (1%). The following are the results of the PLS output for testing significance on the structural model (inner model).

Tabel 4.8
Path Coefficients

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (|O/STDEV|)	P Values
ASIMETRI INFORMASI -> MANAJEMEN LABA	-0.242	-0.229	0.112	2.170	0.015
KARAKTERISTIK PERUSAHAAN -> MANAJEMEN LABA	0.651	0.640	0.139	4.675	0.000
KUALITAS AUDIT -> MANAJEMEN LABA	-0.022	-0.034	0.101	0.224	0.412
MEKANISME GCG -> MANAJEMEN LABA	0.070	0.088	0.133	0.528	0.299

Source: Output of SmartPLS 3.0

Discussion

Based on the results of hypothesis test which performed with inner model, the following results are obtained:

The Effect of Good Corporate Governance Mechanism on Financial Reporting Quality

The test results show a t-statistic value of 0.528 lower than t-table 1.64 and have a positive path parameter coefficient of 0.070. With these results, the hypothesis of the effect of good corporate governance mechanism on financial reporting quality is rejected.

In stakeholder theory, increasing the adoption of good corporate governance mechanisms are expected to be able to produce financial reporting quality and be useful for stakeholders in decision making and reduce earnings management practices. Financial reporting quality the accrual model tested by analyzing whether management practices earnings management or not. The practice of earnings management is a potential result of freedom in applying accrual accounting. The existence of accounting standards and oversight mechanisms can reduce this freedom. However, it is unable to eliminate such freedom because of the complexity and variety of business activities.

The results of this study indicate that the proportion of independent commissioners does not affect earnings management actions. The formation of the board of commissioners is only to fulfill the regulations issued by the Financial Services Authority Regulation which requires companies to have at least 30% of independent commissioners

The results of this study are supported by Yasmeen and Hermawati (2015) and Meliani (2018). However, the results of this study are not in line with the results of the research of Klai and Omri (2011), Fathi (2013), Iswara (2016), and Waweru and Riro (2013) which state that the proportion of independent commissioners influences earnings management, the greater the composition of the independent commissioner, the higher the supervision in the company. Therefore, it can minimize the possibility of managers in making earnings management.

The Effect of Audit Quality on Financial Reporting Quality

The test results show t-statistic value of 0.224 lower than t-table 1.64 and have a negative path parameter coefficient of -0.022. With such results, the hypothesis states that there is an influence of audit quality on financial reporting quality is rejected.

In signaling theory, audit quality is a signal for investors and stakeholders in assessing the quality of financial reporting through financial statement information audited by the Big Four KAP. KAPs affiliated with the Big Four usually have better and more reliable disclosures of financial statement information The results of this study are in line with research from Christiani and Nugrahanti (2016), Luhgiatno (2010) and Rahmadika (2011) which state that the Big Four KAP has not been able to limit earnings management practices. This is because most people have the perception that large-scale accounting firms can provide high audit quality. The public perception was not right, because in reality the company which audited by the Big Four KAP was not proven able to limit the profit management practices of the company. (Luhgiatno 2010). Although the Big Four KAP has a good reputation in the eyes of clients and stakeholders, sometimes they also lose their professionalism so that the auditor's reputation does not become a guarantee in limiting earnings management practices carried out by the company to reduce the quality of financial reporting.

The Effect of Firm Characteristics on Financial Reporting Quality

The test results show the t-statistic value of 4.675 is greater than t-table 1.64 and has a positive path parameter coefficient of 0.651. With such results, the hypothesis which states that there are influences of firm characteristics on financial reporting quality is accepted.

Based on stakeholders' theory, the company will try to disclose mandatory information so that stakeholders continue to place trust in the company, one of which is quality financial statement disclosure, the existence of firm characteristics, namely performance variables are expected to improve financial reporting quality.

According to Supriyono (2018: 123), earnings management is all actions used by managers to influence profits by raising or lowering earnings by their objectives. When associated with the results of this study, its provide evidence that the state of the company's performance (good or bad) triggers the practice of earnings management, management tends to do earnings management using income minimization and income maximization.

The practice of earnings management in these conditions, financial statements quality will decrease because earnings management practices have a negative relationship with the quality of financial reporting due to reducing the usefulness of financial statement information for decision making

The results of this study are supported by research conducted by Raharjo (2017) and Waweru and Riro (2013). Raharjo (2017) concluded that the monitoring and performance variables were proven to affect the quality of financial reporting. This finding indicates that the monitoring and performance variables are factors considered by management in carrying out the process of preparing financial statements.

The Effects of Information Asymmetry on Financial Reporting Quality

The results of this hypothesis show the value of t-statistics 2.170 is higher than t-table 1.64 and has a negative path parameter coefficient of - 0.242. With such results, the hypothesis that there is an influence of information asymmetry on financial reporting quality is accepted.

In signalling theory, the signal theory suggests how companies should provide signals to users of financial statements. Information asymmetry is based on the idea that insiders generally have better information about the company than outsiders. The results of this study are supported by research conducted by Andika and Sukartha (2015) which states that information asymmetry affects earnings management. The results show that information asymmetry is a factor that is highly considered in earnings management actions and presents quality financial reports. The higher of the information asymmetry that occurs between the principal and the agent, the greater of earnings management practices. Information Asymmetry provides an opportunity for managers to act opportunistically, namely to obtain profits, managers can conduct earnings management to mislead owners (shareholders) regarding the company's economic performance.

CONCLUSIONS AND SUGGESTIONS

Conclusion

Based on the results of this research and discussion that have been previously carried out, the conclusion can be drawn as follows:

1. Good Corporate Governance Mechanism does not affect on Financial Reporting Quality
2. Audit Quality does not affect on Financial Reporting Quality
3. Firm Characteristics have a significant effect on Financial Reporting Quality
4. Information Asymmetry has a significant effect on Financial Reporting Quality

SUGGESTION

This study has several limitations that require improvement and development for subsequent research. Here are some limitations and suggestions for further research:

1. This study has a relatively short time for the period 2014-2016, so it is expected that further research can extend the period so the results of the study can be compared and more accurately
2. This study has limitation of research population, so it is expected that further research can expand the scope of the study population and use different sector populations
3. The results of the study state that financial reporting quality proxied by earnings management can be explained by the mechanism of good corporate governance, audit quality, company characteristics, and information asymmetry only 49.90% and 50.10% explained by other factors so that the research model is weak. Based on the limitations of the study, it is expected that further research will add factors that have not been studied that can affect financial reporting quality such as internal control, accounting information systems, and other factors.
4. Measurement of financial reporting quality in this study only uses accrual models, namely earnings management and uses secondary data, namely annual report, it is expected that further research can use other dimensions in measuring reporting quality and using primary data in the form of questionnaires
5. The results of this study state that good corporate governance mechanism and audit quality does not affect financial reporting quality, so the suggestion for further research is to review the effect of good corporate governance mechanisms and audit quality on financial reporting quality with different samples and proxy, so the results can be compared.

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