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USING EFFICIENT CONTRACTING THEORY TO FIND OUT THE COMPANIES' EARNINGS QUALITY

Abstract:

Profit is one of the information from financial statements that is still considered by investors or creditors. Therefore, accounting profits that have good quality are important information for potential investors and creditors in making the right decisions. Management has an information regarding the condition of the company and is likely to change or exaggerate the existing information, so efficient contract requests for financial accounting information is coming from lenders and shareholders. This study aims to examine the effect of leverage, outstanding shares, and good corporate governance on the earnings quality of manufacturing companies listed on the Indonesia Stock Exchange (IDX) during 2020. Leverage is measured by Debt to Asset Ratio (DAR), outstanding shares is measured by Cummulative Abnormal Return (CAR), good corporate governance is measured by the 1st level of ASEAN Corporate Governance Scorecard (ACGS), and earnings quality is measured by earnings quality ratio. The number of samples in this study were 104 companies that was taken by purposive sampling technique, tested using the multiple linear analysis method, and processed using SPSS Statistics 25 software. The results of this study show that outstanding shares have a positive effect on earnings quality, while leverage and good corporate governance have no effect on earnings quality.

Keywords:
Earnings Quality; Leverage; Outstanding Shares; Good Corporate Governance

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Introduction

One thing that companies can do in order to survive in carrying out their operational activities is to use the capital market as a place to obtain additional funds (Amalya, 2018). These additional funds can also be obtained from loans provided by creditors. Besides that, in running a company, financial statements are one of the reports that must be presented where the report focuses on the financial aspects of the company which can be used as a tool to communicate between companies and parties who have an interest in financial data or activities of a company (Efriyanti, Anggraini, & Fiscal, 2012).

One of the information from financial statements that is still considered by investors or creditors is information about accounting profit. A profit can be said to have high quality if it is close to the initial planning or even exceeds the set target, while the earnings quality can be said to be low if the profit presented in the financial statements does not match the reality (Kepramareni, Pradnyawati, & Swandewi, 2021). Therefore, Agustina and Mulyani (2017) state that the profits generated by the company must be analyzed more deeply to see whether the earnings has a good quality.

Earnings quality in general is something that users of financial statements pay attention to for contractual purposes and for making investment decisions (Kepramareni et al., 2021), and that makes a company will definitely try to present the best possible financial statements, especially company profits because the information of the proft will be used by creditors to see whether the company is come under the lending criteria seen from the company's financial condition. By understanding that information from financial statements is very important, every company certainly tries to increase their profits, and often in the end this practice is carried out in an unhealthy way. Therefore, it is necessary to implement good corporate governance.

Corporate governance is a supervisory mechanism for the organization of the company so that the manager or management of the company does not act only to fulfill their own interests, but also thinks about the interests of the managers and owners of the company. Good corporate governance in the proxy mechanism includes the audit committee, the size of the board of commissioners, managerial ownership, and institutional ownership (Puspitowati & Mulya, 2014).

Literature Review And Hypothesis Development

Efficient Contracting Theory

Holthausen (1990) revealed that efficient contracting theory carries the view that a company regulates itself in the most efficient way, so that the company's prospects for survival can be maximized and contribute to shareholders. This theory also assumes that company management is like investors, where they think rationally, which results in management not being able to act only to get the highest profit for the company but must act like an investor (Scott, 2015: 313). Efficient contracts are a significant component of corporate governance, and in order for corporate governance to be said to be good, these contracts must be efficient where the costs incurred must be balanced with the benefits obtained (Scott, 2015: 312).

Efficient contracting theory as explained by Scott (2015:313) studies the role of financial accounting information in reducing information inequality between parties who make a contracts or agreements. Management has an information regarding the condition of the company and is likely to change or exaggerate the existing information. So therefore, efficient contract requests for financial accounting information is coming from lenders and shareholders (Scott, 2015:314).

Leverage

Sadiah and Priyadi (2015) state that leverage can be used as a measuring tool to see the company's ability to use its assets and funds coming from company debt. If the company has a high level of debt, the financial risk is also higher and the company is more likely to be unable to pay its debts. With these problems, companies are indirectly required to incur large amounts of costs and this can have an impact on the company's low profits. Low company profits make the management decide to carry out earnings management, which results a low quality of the company profits (Sadiah & Priyadi, 2015).

Outstanding Shares

The number of outstanding shares is representative of the shares held by the company management and institutional parties where the number of outstanding shares is not static and can fluctuate from time to time, and the outstanding shares will only increase in number if the company adds its shares by issuing additional shares. Outstanding shares in the capital market can be bought or sold by shareholders (Erlinawati & Mawardi, 2015).

Good Corporate Governance

The definition of corporate governance has been presented by the Cadbury Committee (1992, referred to in Claessens, 2003) as a system that regulates and controls companies. The meaning conveyed by the Cadbury Committee is the same as that expressed by Monks and Minow (2008) where corporate governance is defined as a system that regulates and controls companies that generate added value for stakeholders.

The OECD (2015) reveals the objectives of corporate governance, such as to assist in building the environment of trustworthiness, transparency, and accountability needed to encourage long-term investment, financial stability, and business integrity, so as to support stronger growth, as well as more inclusive society. In order to achieve these goals, the principles that underlie the implementation of corporate governance are needed. The principles consist of TARIF (Transparency, Accountability, Responsibility, Independency, and Fairness).

Earnings Quality

Schipper and Vincent (2003, referred to in Wardhani, Putri, & Mulyani, 2020) convey their views regarding earnings quality, where according to them earnings quality is the level of closeness of reported earnings using hicksian income which shows the amount that can be consumed in a fixed period by keep maintaining the company's ability at the beginning and end of the period. Therefore, earnings can be said to have a good quality if the company can earn profits that have the same amount as the amount to be consumed.

Earnings that have a good quality according to the International Accounting Standards Boards or abbreviated as IASB (2009) are profits that provide benefits in decision making. Zarviana, Nur, and Indrawati (2017) also said that earnings can be said to have good quality if they can be used as a good indicator of future earnings or have a strong relationship with future operating cash flows.

Hypothesis Development: The Effect of Leverage on Earnings Quality

Company that has a high level of leverage tends to use accounting policies to provide reports on changes in company profits from time to time which causes the company has low earnings quality. In addition, it is feared that companies with high debt will not be able to pay their debts according to the specified time and it will be more difficult for companies to earn high profits. This statement is in accordance with the results of research conducted by Dewi & Fachrurrozie (2021), where leverage has a negative effect on earnings quality.

On the other hand, research conducted by Wati and Putra (2017) shows that leverage has no effect on earnings quality. In the research it was said that although the level of leverage and company risk is high, it does not mean that the company's earnings quality are not good because the company can still improve the quality of its earnings even though it has a high debt to asset ratio (DAR) if the company can manage debt efficiently, and has more conservative inventory and credit sales management.

Based on the argument above, the research hypothesis can be formulated as follows:

H1: Leverage affects earnings quality.

Hypothesis Development: The Effect of Outstanding Shares on Earnings Quality

The increasing number of outstanding shares can affect the increase in the company's share price because in classical economic law, if there is an increase in demand, the price can also increase (Asyrafani, 2019). Rusliati and Farida (2011, referred to in Marpaung, 2018) reveal that the number of outstanding shares that are responded positively by investors can cause demand for shares to increase, while the number of outstanding shares that are responded negatively by investors can cause a decrease in demand for shares. The decreasing demand for shares made the company's management look for ways to increase the demand for shares, which is by presenting good profits to attract investors.

If the profit presented by the company is good, then investors may be interested in buying company shares and increasing demand for shares automatically affects the number of shares outstanding. However, the presentation of good profits can be done in a bad way, namely by presenting profits that are not in accordance with actual profits where this action can reduce the quality of company profits.

Based on the argument above, the research hypothesis can be formulated as follows:

H2: Outstanding shares affects earnings quality.

Hypothesis Development: The Effect of Good Corporate Governance on Earnings Quality

The possibility of risk carried out by the board of commissioners for their own benefit can be minimized by having good corporate governance. In addition, the trust of investors and creditors to invest and provide loans also increases, so the company has the opportunity to improve its performance which affects the quality of company profits. This is in line with research conducted by Wati and Putra (2017) which shows that good corporate governance has a positive effect on earnings quality. However, the research conducted by Wati and Putra (2017) is not in line with the research conducted by Tuwentina and Wirama (2014), which shows that good corporate governance has no effect on earnings quality.

Based on the argument above, the research hypothesis can be formulated as follows:

H3: Good corporate governance affects earnings quality.

Research Methods

Measurement for Variables

In this study, leverage is measured by Debt to Asset Ratio (DAR) that shows how much of the company's assets are financed by the company's debt; outstanding shares is measured by Cummulative Abnormal Return (CAR) to see the effect of an event on stock prices which indirectly affect the number of outstanding shares; good corporate governance is measured by the 1st level of the ASEAN Corporate Governance Scorecard (ACGS) which is a self-assessment checklist for the implementation of corporate governance which aims to motivate companies to implement good corporate governance and obtain a high score; and earnings quality is measured by Earnings Quality Ratio (EQR).

Data Collection

The type of data used in this research is secondary data. The data are in the form of financial reports and annual reports presented by manufacturing sector companies listed on the Indonesia Stock Exchange (IDX) for the 2020 period. In taking the sample for this research, purposive sampling technique was used where this technique will determine the sample that is considered to represent the population and meet certain criteria. Some of the criteria are:

1) Manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the 2020 period.

2) The company issues a financial report for the period 2020 on the Indonesia Stock Exchange (IDX).

3) The company publishes an annual report for the period 2020.

4) The company has a financial year ending on December 31, 2020.

Data Analysis

The secondary data collected will be processed using Microsoft Excel and SPSS Statistics 25 software for data analysis. Several data analysis methods used in this research are descriptive statistical analysis, classical assumption test, hypothesis testing, and multiple linear regression analysis.

Results And Discussion

Variables	Beta	t-Values
Constant	2.286	0.744
Leverage	-0.350	-0.335
Outstanding Shares	17.855	2.948
Good Corporate	-0.008	-0.234
Governance	0.083	
R-Square	0.055	
Adjusted R-Square	3.008	
F-Tests	1.776	
Durbin-Watson		

*Level of Significance: 5%

Source: Author's Elaboration

Table 1. Regression Model Testing Results

The Effect of Leverage on Earnings Quality

The results of the tests that have been done show that leverage has no effect on earnings quality. The results of this study are in line with research conducted by Wati and Putra (2017). According to them, if the company is able to manage its debt efficiently, and has a more conservative inventory management and credit sales, then a company with leverage, especially a high debt-to-asset ratio, can improve its earnings quality compared to a company with a low debt-to-asset ratio.

The calculation of earnings quality by comparing net income with Cash Flow from Operations (CFO) can also be said makes the leverage not affect the company's earnings quality. This can happen because the calculation of earnings quality only concerns on operating activities, so it cannot reflect the impact of leverage that goes into financing activities on the quality of profits generated by the company.

The Effect of Outstanding Shares on Earnings Quality

Based on the results of the tests that have been done, it can be seen that the outstanding shares has a positive effect on earnings quality. The increase in the number of outstanding shares can occur because of the positive response given by investors that can be obtained when the company publishes financial statements. If the profits presented in the company's financial statements can provide needed and useful information for investors, it will have an effect on increasing the company's stock price.

The increasing share price of the company indicates that there is an increase in the demand for the number of company shares. In addition, an increase in stock prices can also increase the returns received by investors. With these events, the company's management can see that there is a positive response from investors who are given information related to company profits published in the financial statements. From there, the company's management will be motivated to continue to provide quality profits from year to year.

The Effect of Good Corporate Governance on Earnings Quality

The results of the tests that have been done show that good corporate governance has no effect on earnings quality. The results of this study are in line with previous research conducted by Tuwentina and Wirama (2014). According to them, the success or failure of implementing good corporate governance can only be seen in the long term. Therefore, the success of implementing good corporate governance in companies cannot be compared with the calculation of profitability which can be seen in the short term.

The implementation of good corporate governance is also inseparable from the internal mechanism. However, the internal mechanism of good corporate governance is often not well optimized by the company so that the control and supervision of management becomes weak which results in the quality of earnings generated and reported by management become doubtful (Puspitowati & Mulya, 2014; Soly & Wijaya, 2017).

Conclusions

Based on the results of the tests carried out, it can be concluded that leverage has no effect on earnings quality because the calculation of earnings quality that only looks at net income and cash from operating activities cannot reflect the leverage included in the company's financing activities.

The test results on the outstanding shares indicate that outstanding shares has an effect on earnings quality. The existence of this influence is caused by the positive response given by investors when the company publishes financial statements which has an effect on increasing stock prices and the demand for the number of company shares, as well as returns received by investors, so that companies are motivated to provide quality profits from year to year.

Good corporate governance has no effect on earnings quality based on the results of the tests that have been carried out. The success of implementing good corporate governance can only be seen in the long term that cannot be compared with the calculation of profits which can be seen in the short term. Internal mechanisms of good corporate governance that have not been implemented and optimized optimally also cause the quality of earnings reported become doubtful due to weak control and supervision of management.

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