VALUATION OF FINANCIAL REPORTING QUALITY: IS IT AN ISSUE IN THE FIRM'S VALUATION?

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Abstract

The aim of this research is to test the determinant of financial report quality and its consequences to the company's value. The sample of this study is 85 go public companies listed in the Indonesia Stock Exchange for 5 years observation period in 2016 until 2020. Hence, it has total of 425 observations. Data was analyzed using path analysis. The results found that innate factors from financial reporting quality consists of dynamic factor (operation cycle and sales volatility) as well as static factor (firm size). These factors support to achieve financial reporting quality and able to provide positive response to market. On the other hand, static factor (firm age) and institution risk factor (leverage) are not able to produce financial reporting quality. Thus, it cannot be considered as an economic decision making for an investor.

1. INTRODUCTION

The general overview on the financial report quality had been studied by many researchers. Therefore, an agreement had been created to support the convergence of accounting standard harmonization that will be impacted in the financial reporting. Some phenomena in accounting scandal occurred in early 21st century had showed us the weakness in the financial reporting quality. The financial report quality depends on the value on the accounting report, hence, it is important for a company to provide high quality financial report. Research shows that quality financial report will be impacted and useful to make an investment decision. The concept of quality financial report is not only containing financial information but also non-financial which will be useful to make an economic decision (Herath and Albarqi, 2017).

The quality of financial report will be studied from two different aspects. Firstly, the quality of financial report shows the company's performance which reflected on the profit information. It can be said that financial report information has high quality if profit obtained in the current year can be used as an indicator to generate profit in the future (Dang et al., 2020), or as cash revenue in the future (Noury et al., 2020). Secondly, the quality of financial reporting is related to the company's market performance which listed in the stock exchange. The strong relationship between profit and stock's market price proofed that financial reporting information will be responded positively by either market or investors (Dang et. al., 2020).

Studies related to the quality of the financial reporting can be done by using two different approaches. The first approach is to test the causes of the financial report quality. In this approach is to examine the company's internal causes or characteristics. Those are dynamic

innate (operational cycle and sales volatility), static (company's size and its age), and institution risk factor (leverage) (Fanani, 2009). The second approach is the external market's respond to determine the majority of which is using the financial reporting. This respond will be determined the value of the company (Al-Dmour et al., 2018). Lonkani (2018) stated that the company's value is not merely related to the external stakeholders' relationship or the users of financial reporting such as investors and creditors, however, it is also considering an implicit relationship to be evaluated in the valuation process. Beside that the meaning of company's valuation is not solely for one group of people (in this case investors), who will obtain the maximum level of gain from company's operational activities.

This paper is to examine the determinant of the quality of financial reporting and its consequences to the company's valuation. The proxy of innate factors involve dynamic factor (operational cycle and sales volatility), static factors (firm size and its age), and lastly institutional risk factor (leverage). This study contributes both theoretically and practically. Theoretically, this research shows that valuation of clean surplus theory which determine the firm's market value reflected in the financial report component (Feltham & Ohlson's, 1995). This study is employed more than one financial reporting quality (Cornel & Landsman, 2003). Practically, the findings of this study will provide information to management in order to produce a quality financial report, which will then be responded positively by market and investors. Furthermore, a quality financial reporting will benefit investors and stock market's analysts (investors, brokers and market security analyst) in making investment decision.

2. LITERATURE REVIEW

2.1 Quality of Financial Report

According to IASB (2018), the information quality revealed in the firm's financial report can help users in evaluating the benefit of the financial report. Therefore, financial report must be presented accurately, comparable, verifiable, on time and understandable. Hence, it must be transparent, and error free. It is important that the financial report must be on time and predictable as an indicator to produce high quality financial report (Gajevszky, 2015). The qualitative characteristics of financial information consist of: relevance, accurate representation, understandable, comparable, verifiable and lastly on-time.

2.2 Information Usefulness of Accounting

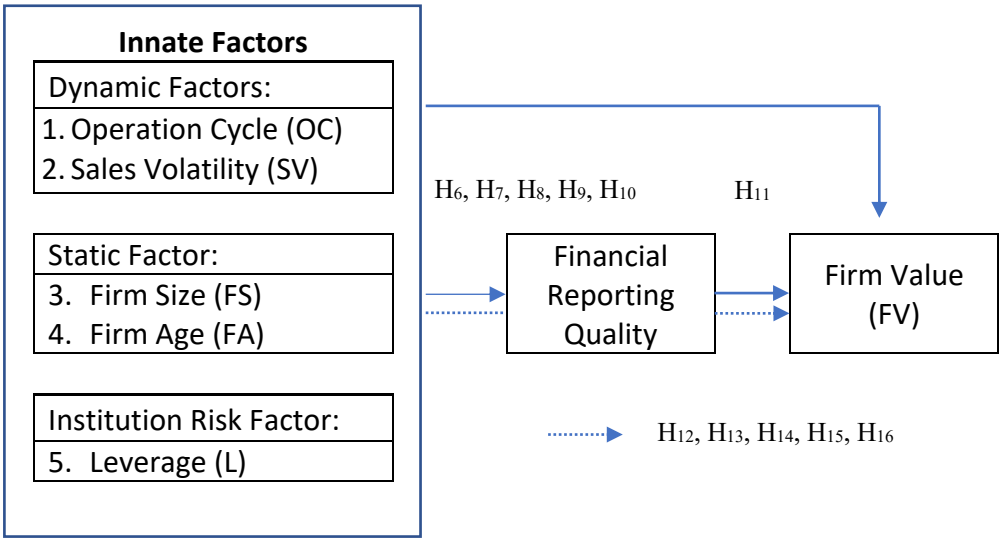
An organization which organized the accounting standard fully support that financial report has the purpose of presenting financial information which will benefit users. The purpose is to have a better understanding of the firm's financial position (IASB, 2018). Thus, users are able to make economic decision. Accounting information is used to evaluate the business performance and also it is useful for owners to do some analysis in evaluating business operation. Financial ratio can be used as an indicator to compare its performance against other firms within the same business or industry standard (Vitez, 2019). This can help owners to understand how good its company compare to others is.

2.3 Clean surplus theory

Clean surplus theory is a foundation theory that relevance to the accounting information value. This theory mentions that the firm's value is reflected in the accounting data which is

showing on the financial report (Ohlson, 1995). Clean surplus theory had an impact on the development of financial accounting theory, especially it is able to demonstrate that the firm's value has an equal value with dividend financial accounting variable or cash flow. This was then followed by more research in predicting profit (Scott, 2015: 233; Schroeder et al., 2020). According to Djaballah (2019), financial information has the function of forecasting and analysis which describe the firm's condition. It shows that financial report is not only as information perspective for users but also has the benefits to evaluate the usage of the financial report.

2.4 Conceptual Framework



Picture 1
The Conceptual Framework of
Valuation of Financial Reporting Quality and Firm Value

2.5 Hypothesis

2.5.1 Testing the impact of Innate Factors of Financial Reporting Quality to Firms' Value

Innate factors of the quality financial reporting consist of operation cycle, sales volatility, firms' size and firms' age. In this case firms' operation cycle is the most important variable in order to operate a company. Hence, it needs a firm's operation cycle which can be understandable by all employees (Arachchi et al., 2017). In regards to high sales volatility shows that sales information has wrong estimation which can cause un-persistence results (Nezami et. Al., 2018). The unstable sales proxied by high sales volatility will make lower firms' valuation and vice versa.

Majority of the research found that size and age of a firm influences the value of a company. Big firms have stable financial condition (Rouf, 2018). It is therefore increase the company's value, hence, it attracts investors. As a result increase the stock market price, and will affect an increase on the value of one firm.

Based on the study of innate factors of the valuation of financial reporting on the firm value. Thus, hypotheses can be formulated as follow:

H_1: The longer operational cycle of a firm is resulted on the low firm's value.
H_2: The higher sales volatility of a firms is resulted on the low firm's value.
H_3: The bigger of a firm's size resulted in higher firm's value
H_4: The longer of a firm's age resulted in a higher firm's value
H_5: The higher of the leverage of a company resulted in high quality firm's value

2.5.2 Testing the impact of Innate Factors on Financial Reporting Quality

Firm's operational cycle will determine the quality of financial report either good or bad. A firm's with longer operational cycle shows unexpected things as inaccurate estimation will occur. Some errors of estimation will produce low accrual value as a result it will have low quality of financial reporting (Dechow & Dichev, 2002). Sales volatility exhibits the ability to forecast the cash flow in the future. High sales volatility will produce low financial report performance, it is due to the some noises in the firm's profit (Cohen, 2006).

Furthermore, the firm's size shows that a firm with a larger scale is more stable with better operational condition. Thus, it is unlikely to have some errors on the estimation. Besides that, a larger firm will have the ability to do some diversifications as it will reduce errors on the estimation (Gu et.al. 2002). The longer firm's existence will have stronger operation. As a result the financial performance will have small accrual variability (Gu et.al, 2002). Thus, a firm is more trusted in regards to the leverage. Hence, creditors will be more confidence in providing debts and also a firms will have some privileges in paying its debts (Cohen, 2006). Based on the arguments in the firm's valuation, thus, hypotheses can be formulated as follows:
H_6: The longer a firm's operational cycle is resulted in low quality financial report.
H_7: The higher sales volatility is resulted in low quality financial report
H_8: The bigger of a firm's size is resulted in high quality financial report
H_9: The older of a firm's age is resulted in high quality financial report
H_{10}: The higher of a firm's leverage is resulted in high quality financial report

Shin and Kim (2019) as well as Dempster and Oliver (2019) emphasized that the high compliance on the accounting standard consistently will show the factual condition of one firm. This research will use the accrual value as proxy in the fundamental ability of a firm to sustain its existence. By using the higher standard accrual size quality is resulted in low accrual usage. The higher number of quality financial reporting is resulted in high prediction of the market value in the future (Siladjaja and Anwar, 2020). Based on the innate factor of the quality financial report evaluation, thus, a hypothesis can be formulated as follow:
H_{11}: The higher financial report quality is resulted in high of a firm's valuation.

2.5.3 Testing of the Innate Factors of Financial Reporting Quality and its impact on the Firm's Value

As discussed earlier there are two approaches in studying financial reporting quality. Elayan et. al (2016) found that there are some phenomenon in the stock exchange to see high quality financial report performance. It is obviously to help investors to predict a firm's financial performance in the future. Eskandari and Foumani (2016) shows that high quality financial report will influence the management's ability to predict the market reaction. Based on the arguments

about innate factor of the financial report quality and its impact on a firm's value. Hypotheses can be formulated as follows:

H_{12}: The longer of a firm's operational cycle is resulted in low quality of financial report, hence, low firm's valuation

H_{13}: The higher sales volatility of a firm is resulted in low quality of financial report, hence, low firm's valuation

H_{14}: The larger of a firm's size is resulted in high quality of financial report, hence, high firm's valuation

H_{15}: The older of a firm's age is resulted in high quality of financial report, hence, high firm's valuation.

H_{16}: The higher the leverage of a firm is resulted in high quality of financial report, hence, low firm's valuation.

3. RESEARCH METHODS/METHODOLOGY

3.1 Research Approach and Sample

This research is using quantitative approach and testing a theory by formulating some hypotheses. Then, data is collected to support or argue the hypotheses that had been formulated. The population in this research is all of the companies listed in Indonesia Stock Exchange (BEI). The purposive sampling is applied in this research, only companies which had been doing their Initial Public Offering (IPO) in the Indonesia Stock Market before 2016 with completed data will be included in the sample. Therefore, 85 companies with 5 years observations from 2016 to 2020 are included. Thus, a total of 425 observations.

3.2 Research Variables

3.2.1 Innate Factors

Dynamic Factors:

1. Operation Cycle (OC)

   Operation Cycle is measured by using the time average between purchasing inventory and the cash flow received by the seller. It is the whole business transaction from the customer (Dechow, 1994)

$$\text{Operation Cycle}_{it} = \frac{(ARit + ARit - 1)/2_{it}}{\text{Salesit}/360_{it}} + \frac{(\text{Invit+Invit-1})/2_{it}}{\text{COGSit}/360_{it}}$$

   Description: AR_{it} = Account Receivables i year t, AR_{it-1} = Account Receivables i in the previous year, Inv_{it} = Inventory i year t, $COGS_{it}$ = Cost of Goods Sold i year t

2. Sales Volatility (SV)

   Sales Volatility is the degree of sales spread or spread index distribution of sales (Dechow dan Dichev, 2002).

$$\text{Sales Volatility}_{it} = \frac{\sigma(\text{Sales of 5 Year}_{it})}{\text{Asset Total}_{it}}$$

   Description: Sales of 5 $Year_{it}$ = Sales firm i since 2016-2020, Total Asset $Year_{it}$ = Total Asset firm i since year t

Static Factor:

3. Firm Size (FS)
   Firm size is the scale of one company (Dechow dan Dichev, 2002).
   Firm Size_{it} = Logaritma Total Assets

4. Firm Age (FA)
   Firm age is the length of the operation of a firm (Gu et al., 2002).
   Firm age = Year observation – Year founded

Institution Risk Factor:

5. Leverage (L)
   Leverage is funding for operational or investment from external (DeAngelo et al., 1994).

$$\text{Leverage}_{it} = \frac{\text{Liability Total}_{it}}{\text{Asset Total}_{it}}$$

Description: $\text{Liability Total}_{it}$ = Total debt firm i year t, Asset Total_{it} =Total assets firm i year t

3.2.2 Financial Reporting Quality (FRQ)

Financial Reporting Quality is measured by using accrual quality which is revenue that is acknowledged at the time of a firm's existence. Due to the hand-over of goods to external and some expenses or liabilities from the purchase of goods.

$$\text{Accrual Quality}_{it} = \beta_0 + \beta_1 \frac{CFO_{it-1}}{Asset\ Total_{it}} + \beta_2 \frac{Sales_{it}}{Asset\ Total_{it}} + \beta_3 \frac{Asset\ Total_{it+1}}{Asset\ Total_{it}} + \beta_4 \frac{Equity\ Book\ Value_{it+1}}{Equity\ Market\ Value_{it}} + \epsilon_{it}$$

Description: TA_{it} = Firm's Net Income minus cash flow of firm i year t, CFO_{it-1} = Operational cash flow firm i year t, Asset Total_{it} = Total Assets firm i year t, Sales_{it} = Sales firm i year t, Equity Book Value = Stock price * number of stock shares firm i year t, Equity Market Value = Equity total * number of stock shares firm i year t

3.2.3 Firm Value (FV)

Firm value is measured by using Tobin's Q ratio which represents the firm's value by combining both book value and market equity's value. This measurement is better as it summarized future information which relevant to investment decision. Furthermore, it provides information about market's perception toward firm's valuation from many different factors such as investors. According to Suhadak et al. (2020) the larger ratio of Tobin's Q shows that a firm has good and positive prospect.

$$Tobins'Q_{it} = \frac{Total\ Market\ Value_{it} + Total\ Book\ Value\ of\ Liabilities_{it}}{Total\ Book\ Value\ Asset_{it}}$$

3.3 Statistics Analysis

Data was analyzed using path analysis. One of an important components in doing path analysis is path diagram. Path diagram is produced to represent causal relationship among research variables.

Structural Model I: $FV = \beta_0 + \beta_1 OC_{it} + \beta_2 SV_{it} + \beta_3 FS_{it} + \beta_4 FA_{it} + \beta_5 L_{it} + \varepsilon_{it}$

Structural Model II: $FRQ = \beta_0 + \beta_1 OC_{it} + \beta_2 SV_{it} + \beta_3 FS_{it} + \beta_4 FA_{it} + \beta_5 L_{it} + \varepsilon_{it}$

Structural Model III: $FV = \beta_0 + \beta_1 FRQ_{it} + \varepsilon_{it}$

Structural Model IV: $FV = \beta_0 + \beta_1 OC_{it} + \beta_2 SV_{it} + \beta_3 FS_{it} + \beta_4 FA_{it} + \beta_5 L_{it} + \beta_5 FRQ_{it} + \varepsilon_{it}$

4. RESULTS AND DISCUSSIONS

Tabel 1 exhibits descriptive statistics in this research.

Table 1
Descriptive Statistics

	N	*Minimum*	*Maximum*	*Mean*	*Std. Deviation*
Operation Cycle (OC)	425	.00	4861.52	144.77	426.09
Sales Volatility (SV)	425	.00	58526.67	1119.39	5133.43
Firm Size (FS)	425	5.89	15.97	11.59	1.68
Firm Age (FA)	425	2.00	63.00	31.48	1.52
Leverage (L)	425	.00	3.32	.41	.39
Financial Reporting Quality (FRQ)	425	.00	301331.46	7253.63	24311.82
Firm Value (FV)	425	0.02	41.87	2.24	4.68
Valid N (*listwise*)					

Sources: Indonesian Stock Exchange

4.1 F-test

The purpose of the F test is to confirm whether independent variable in the regression model is feasible to be included in the research to examine the dependent variables. Result of the F-test is presented in Table 2.

Table 2
Results of F-test Model 1
ANOVA[a]

Model		**Model 1**		***Model 2***	
		F	*Sig.*	F	*Sig.*
1	*Regression*	22.182	.000[b]	26.580	.000[b]
	Residual				
	Total				

a. *Dependent Variable*: Model 1 (Firm Value) Model 2 (Financial Reporting Quality)
Source: Analyzed Financial Report, 2021

Table 5 shows that the value of F-test 22.182 (model 1) and 26.580 (model 2) with sig. 0,000 < 0,05, hence, it can be concluded that the model is feasible.

4.2 Hypotheses Test (T-test)

4.2.1 Structural Model Test I (Hypotheses 1 until Hypotheses 5)

The purpose of T-test (hypotheses test) is to know whether there is an impact on the independent variable with significant level of 0.05 (α = 5%). The following is the result of T-test (Table 3) based on the structural model I:

Structural Model I: $FV = \beta_0 + \beta_1 OC_{it} + \beta_2 SV_{it} + \beta_3 FS_{it} + \beta_4 FA_{it} + \beta_5 L_{it} + \varepsilon_{it}$

Table 3
Results of Model 1 (H_1, H_2, H_3, H_4, H_5)
Coefficients[a]

	Model	***Standardized Coefficients*** **Beta**	**t**	***Sig.***	**Description**
1	(*Constant*)	13.550	7.839	.000	-
	Operation Cycle (OC)	-.002	-4.541	.000	Hypothesis supported
	Sales Volatility (SV)	-.000	-3.854	.000	Hypothesis supported
	Firm Size (FS)	.958	6.598	.000	Hypothesis supported
	Firm Age (FA)	-.001	-1.471	.142	Hypothesis not supported
	Leverage (L)	-.041	-.073	.942	Hypothesis not supported

a. *Dependent Variable*: Firm Value (FV)
Source: Analyzed Financial Report, 2021

4.2.2 Structural Model Test II (Hypothesis 6 until Hypothesis 10)

Table 4 shows the result of T-test with significance level 0,05 (α = 5%). Hence, the formula for structural model II as follows:

Structural Model II: $FRQ = \beta_0 + \beta_1 OC_{it} + \beta_2 SV_{it} + \beta_3 FS_{it} + \beta_4 FA_{it} + \beta_5 L_{it} + \varepsilon_{it}$

Table 4
Results of Model 2 (H_6, H_7, H_8, H_9, H_{10})
Coefficients[a]

	Model	***Standardized Coefficients*** **Beta**	**t**	***Sig.***	**Description**
1	(*Constant*)	-90008.271	-10.237	.000	-
	Operation Cycle (OC)	.546	.199	.842	Hypothesis not supported
	Sales Volatility (SV)	-1.260	-4.641	.000	Hypothesis supported
	Firm Size (FS)	8388.561	11.354	.000	Hypothesis supported
	Firm Age (FA)	1.762	.510	.610	Hypothesis not supported
	Leverage (L)	-3737.551	-1.318	.188	Hypothesis not supported

a. *Dependent Variable*: Financial Reporting Quality (FRQ)
Source: Analyzed Financial Report, 2021

4.2.3 Structural Model Test III (Hypothesis 11)

Table 5 is the result of the structural model test III with significance level of 0.05 (α = 5%). The formula as follows: Structural Model III: $FV_{it} = \beta_0 + \beta_1 FRQ + \varepsilon_{it}$

Table 5
Results of Model 3 (H_{11})
Coefficients[a]

Model	*Standardized Coefficients* Beta	t	*Sig.*	Description
(*Constant*)	2.354	9.952	.000	-
Financial Reporting Quality (FRQ)	-1.630	-1.746	.081	Hypothesis not supported

a. *Dependent Variable*: Firm Value (FV)
Source: Analyzed Financial Report, 2021

4.2.4 Structural Model Test IV (Hypothesis 12 until Hypothesis 10)

Table 6 is the result of the structural model test III with significance level of 0.05 (α = 5%). The formula as follows:

Structural Model IV: $FV = \beta_0 + \beta_1 OC_{it} + \beta_2 SV_{it} + \beta_3 FS_{it} + \beta_4 FA_{it} + \beta_5 L_{it} + \beta_5 FRQ_{it} + \varepsilon_{it}$

Table 6
Results of Model 4 (H_{12}, H_{13}, H_{14}, H_{15},H_{16})
Coefficients[a]

	Financial Reporting Quality	Firm Value	Total Effect	
Operation Cycle (OC)	.546	-.002	-.001	Hypothesis supported
Sales Volatility (SV)	-1.260	-.000	-0.000	Hypothesis supported
Firm Size (FS)	8388.561	.958	8036.241	Hypothesis supported
Firm Age (FA)	1.762	-.001	-.002	Hypothesis not supported
Leverage (L)	-3737.551	-.041	153.240	Hypothesis not supported

a. *Dependent Variable*: Firm Value (FV)
Source: Analyzed Financial Report, 2021

4.3 Interpretation of Research Findings

The direct test negatively of operation cycle to the firm's value is supported (H1). However, there is no direct impact on operation cycle to the financial reporting quality (H6). This study is supported indirect impact negatively on operation cycle to the firm's value toward financial reporting quality (H12). This result is supported Arachchi et al. (2017) dan Dechow dan Dichev (2002). It shows that the longer operational cycle causes higher uncertainty. Thus, it makes an interference on the accrual and reducing the ability in predicting cash flow in the future. This findings are in favor of direct impact negatively of sales volatility to the firm's value (H2) and also direct impact negatively of sales volatility to the financial reporting quality (H7). Furthermore, this research is agreed that there is indirect impact negatively on sales volatility to the firm's

value through financial reporting quality (H13). This results support Nezami et al. (2018) dan Cohen (2006). The fact describes high sales volatility. Yet, research shows that profit is still able to predict cash flow in the future as the generated profit does not contain too many problems (Dechow dan Dichev 2002).

There is a direct impact positively on the firm's size to the firm's value (H3) as well as direct impact positively of the firm's size to the financial reporting quality (H8). This study is also supported indirect impact positively of the firm's size to the firm's value through financial reporting quality (H14). This research supports Rouf (2018) dan Gu et al. (2002). It can be said that the firm's size is a static innate factor, it means that the firm's size can have an impact on the financial report quality as it has the ability to do some diversifications on the business portfolio variations and relatively high politic cost. The result is better not to support direct impact positively on firm's age to the firm's value (H4) and direct impact positively on firm's age to the financial reporting quality (H9). Results also not supported indirect impact positively of the firm's age to the firm's value through financial reporting quality (H15). As a result this study does not support Rouf (2018) dan Gu et al. (2002). Descriptive statistic data shows the average of the firms' age is 31 years. However, there is also a firm that is only 2 years of age. Therefore, this firms does not have too many experiences in running a company's operations. Further, findings do not support direct impact negatively on leverage to the firm's value (H5) and direct impact of leverage to the financial reporting quality (H10). Besides that, this study does not support indirect impact positively of leverage on the firm's value through financial reporting quality (H16). This research does not support Rouf (2018) dan Cohen (2006). In this research the average leverage is relatively small that is .14, hence, it cannot be the main factor that can increase creditor's confidence to loan their money to the company.

CONCLUSION

The quality of financial reporting is related to the overall company's performance. It is reflected in the firm's profit. The first opinion stated that quality profit is reflected on the sustainability of stable net profit. Later, the second opinion claimed that the quality of financial reporting is related to the market's performance in the stock exchange. The stronger relationship between profit and market reward shows that high financial report performance. The findings of this research exhibits information on the innate factors from the financial reporting quality. It involves some factors such as dynamic factor (operation cycle and sales volatility) and static factor (firm size). These factors are needed to achieve financial reporting quality and is able to provide positive respond to the market. On the other hand, static factor (firm age) and institutional risk factor (leverage) are not able to produce high quality financial reporting. Hence, these factors are not used by investors to make an economic decision.

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