CHAPTER I
INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Financial reporting is a source of financial information for company to be used as a basis for decision makings such as the assessment of management performance, the determination of management compensation and shareholders' dividend etc. (Purwanti, 2010). A company chooses accounting method in accordance with its condition. Suwardjono (2005) states that in order to anticipate unstable economic condition, company will cautiously present the financial reporting by firstly recognizing the cost or loss that will likely to happen before recognizing the future income or profit. These cautious actions are often referred to as conservatism in accounting. Watts (2003) and Mutmainah (2012) argue that conservatism is one of the characteristics that is important for reducing agency costs and improving the quality of financial reporting information that will eventually improve the value of the company and its stock price.

The quality of financial reporting can be viewed in two viewpoints. The first view declares that the quality of financial reporting is related to the company's overall performance that is reflected in its profit. A company's financial reporting information is considered high in quality if the current-year profit can be a good indicator for the upcoming-year profit (Lev and Thiagarajan, 1993 in Fanani, 2009). The second view states that the quality of financial reporting is related to the company's shares performance on the capital market. The stronger the relationship between the profit and the market return, the higher the financial reporting information (Lev and Thiagarajan, 1993 in Fanani, 2009). As stated by Watts, 2003 (in Fajri, 2013), conservatism in accounting is the variable necessary in order to recognize profit rather than loss.

Financial report scandals have been recorded to happen in various companies across sectors in Indonesia. Mining sector will be the object selected in this study because various cases of accounting data manipulation was found in a number of Indonesia's mining companies. In 2010, as reported in Tempo.com, Indonesia Corruption Watch (ICW) reported three mining companies owned by Bakrie Group to Directorate General of Taxes. Indonesia Corruption Watch (ICW) suspected that reporting manipulation that is done by PT Bumi Resources Tbk. (Bumi) since 2003-2008 and its subsidiaries, PT Kaltim Prima Coal (KPC), PT Arutmin Indonesia (Arutmin), have caused Indonesia to suffer financial loss amounted US$ 620.49 million. Based on ICW calculation using several primary data including audited financial report, the result shows Bumi revenue in period 2003-2008 is lower as much as US$ 1.06 billion than what it should have been. As a result, it is estimated that Indonesia is suffering financial loss from Coal Production Fund (royalty) that is not paid for US$ 143.29 million (www.tempo.com).

Another case from mining company in 2011 is done by PT Ancora Mining Service (AMS). PT Ancora Mining Service was reported to Directorate General of Taxes by Forum Masyarakat Peduli Keadilan (FMPK) in suspicion of manipulating financial report. Indication that there is a possibility of manipulation is seen because there is income amounted Rp 34.9 billion but there is no movement in investment. Other than that, it was found that there is payment of interest as much as Rp 18 billion while admitted to have no debt. FMPK also found evident of receivable amounted Rp 5.3 billion with no apparent proof of transaction (www.republika.co.id).

Some previous researchers mention that analysis on financial reporting quality can be conducted with two approaches (Cohen, 2003; Francis et al. 2004; and Pagalung, 2006 in Fanani 2009). The first approach is to analyze factors that affect the quality of financial reporting, and the second approach is to study to which extent the financial reporting quality is being responded by the users of financial reports. This research will be using the first approach as it is related to the internal factors of company. This research will focus on the characteristics of firms with a study of dynamic and static factors, and institutional risk. Dynamic and static factor is chosen because it is an innate factor that determine the quality of financial reporting. It is also a core factor in this research. The innate factor consists of the operating cycle of the company, the sales volatility, the age of the company, and the size of the company. While the risk of institutions is another determining factor that is the internal factors of the company, consists of liquidity and leverage. This study will not discuss all the factors that affect the quality of financial reporting. In this study, the author will use operating cycle and firm size to represent the innate factors, while leverage will be used to represent the risk of the institution.

Company with longer operating cycle may cause greater uncertainty and error estimation, therefore results in low quality of financial reporting. This supports the previous researches proven by Gu et al (2002), Francis et al (2004), and Hidayat (2006) that shows operating cycle to have positive effect on the quality of financial reporting, while researches done by Dechow & Dichev (2002), Cohen (2003), and Fanani (2009) shows that operating cycle has negative effect on the financial reporting quality.

Previous researchers have shown different results on the relationship between company size and the quality of financial reporting. According to Fajri (2013), company size has a positive effect towards the quality of financial reporting. Company size may affect its management ability to operate the company with a variety of situations and conditions it faces. Theoretically, a larger company would normally have greater certainty and rate of return than a relatively small company therefore reduce uncertainties about the company's future prospect. This can help predict the risks that will probably happen if investors were to invest in the company. Thus, the larger the size of the company, the more transparent and accountable the company will be in improving the quality of financial reports to the public. However, research done by Fanani (2009), Cohen (2003), and Francis et al (2004) shows that company size has a negative effect to the quality of financial reporting. Gu et al. 2002 (in Fanani 2009) stated that big company has more stable and more predictable operating activities that would result in low possibility of error estimation.

Leverage is a tool to measure how far a company depends on creditors in funding the company assets. Companies with high leverage means it relies heavily on external borrowing to finance its assets, while low leveraged companies use their own capital to fund the assets (Sulistyo, 2010). According to Fanuel, Othniel, and Tobink (2008:596), leverage is a measure of debt to total capitalization of a company. High ratio of leverage indicates excessive debt and the possibility of the company being incapable to produce sufficient earnings to meet its obligations (bonds). Fanani (2009) stated that the magnitude of a company's leverage will cause the company to improve the quality of the financial reporting in order to maintain good performance in the eyes of investors and creditors. Hence, the creditors could have confidence in the company, remain to procure funds.

The above mentioned discussion motivates the author to study the issue related to the measurement of the financial reporting quality in terms of profits representations in accordance with the first view mentioned above, using conservatism as the proxy to measure the quality of financial reporting. Because of different results shown by a number of previous researchers, the author is interested to further analyze about whether operating cycle, firm size, and leverage has significant or insignificant effect on the quality of financial reporting. The research object used in this study is mining companies listed in IDX period 2015-2017.

Based on the background, the author has chosen the title of the study **"Analysis of the Effect of Operating Cycle, Firm Size, and Leverage towards the Quality of Financial Reporting: A Study on Mining Companies Listed in IDX Period 2015-2017".**

1.2 PROBLEM LIMITATION

Due to the complexity of the problem, prior studies suggested that the problem limitation is important to facilitate the author to be more focused on certain problem. This study's problem limitation will be limited as follows:

1. The research will examine three variables affecting the quality of financial reporting, namely Operating Cycle, Firm Size, and Leverage
2. The research is focused on mining companies listed in IDX.
3. The research period is limited to 2015-2017.

1.3 PROBLEM FORMULATION

Based on the background, the author identified the following problems:

1. Does the operating cycle of the company affect the quality of the financial reporting?
2. Does the size of the company affect the quality of the financial reporting?
3. Does the leverage affect the quality of the financial reporting?
4. Do operating cycle, size, leverage of the company simultaneously affect the quality of the financial reporting?

1.4 OBJECTIVE OF THE RESEARCH

The objectives of the research are:

1. To analyze and provide empirical evidence on the impact of the operating cycle of the company towards the quality of the financial reporting;
2. To analyze and provide empirical evidence on the impact of the size of the company towards the quality of the financial reporting;
3. To analyze and provide empirical evidence on the impact of the leverage of the company towards the quality of the financial reporting;
4. To analyze and provide empirical evidence on the impact of operating cycle, sales volatility, firm size, and leverage of the company towards the quality of the financial reporting.

1.5 BENEFIT OF THE RESEARCH

1.5.1 THEORETICAL BENEFIT

This research is expected to provide evidence to develop and strengthen the results of previous researches as well as to give reference to future studies about the effect of operating cycle, firm size, and leverage on the quality of financial reporting.

1.5.2 PRACTICAL BENEFIT

a. For company

This research is expected to provide a reference to the management of the company in producing a high-quality financial reporting. The result of this research is expected to provide the standard setters an input and feedback in the making and evaluation of accounting standards. The outcome of this research can as well be used to evaluate the quality of financial reporting of public companies listed in the Indonesia Stock Exchange.

b. For designate investors

Factors that affect the quality of financial reporting need to be taken into the consideration before making an investment decision. The results of this study are expected to provide useful information for the designate investors before making investment decision in the company.

1.6 SYSTEM OF WRITING

The systems of writing of this study is divided into five chapters, which are presented as follows:

CHAPTER I: Introduction

This chapter contains the description about the background of the study, problem limitation, problem formulation, objectives of the study, benefit of the study, and the systems of writing.

CHAPTER II: Literature Review and Hypothesis Development

This chapter contains the description about the theoretical background of the study, previous researches which are related to this study, hypothesis development, research model, and framework of thinking.

CHAPTER III: Research Methodology

This chapter contains the description about the research design of the study, the population and sample used, data collection and analysis method. Besides, it also includes variable definition and measurement.

CHAPTER IV: Data Analysis and Discussion

This chapter contains the general view of “Research Object”, data analysis, descriptive statistic, the result of data quality and hypothesis testing, and also the discussion of the study result obtained.

CHAPTER V: Conclusion

This chapter contains the description about the conclusion from the results of the study conducted and the implication that are useful for the users or readers of this study.