

# CHAPTER I

## INTRODUCTION

### 1.1 Background of Study

Indonesia is in fourth place in terms of population and its consumptive level (wartaekonomi.co.id, 2020). According to the Central Bureau of Statistics, Indonesia has 270 million people (*sensus.Biro Pusat Statistik.go.id*, 2020). Out of 270 million people, 181 million people are categorized as unbanked people, which means about 67% of Indonesian do not have access to banks (www2.GBGroupplc.com, n.d.). As the population of this consumptive country increase, their needs for funds will also increase. People that have access to banks can borrow money or credit through banks. However, for the unbanked people, they can go to the financial institution.

Financial institutions are business entities that carry out financing activities in the form of funding or capital goods to individuals and ventures (*ojk.go.id*, n.d.). Financial institutions provide financing activity with simpler terms and faster processes (Nababan et al., 2015). Thus, it supports the purchase of goods and business of individuals and companies. Financial institutions that provide funds and credit to unbanked people complement bank's role and work hand in hand in increasing country's economic growth.

Indonesia's high consumption and large population have attracted investors to invest in this industry. To make an optimal financial decision, investors and creditors need reliable financial information, especially reliable information of income. The information of income shows company's current performance. This information can also be used to predict company's future performance. The information of income is essential for investors because the amount of return on their investment depends on it. Creditors need the information to know the ability of a company in paying their obligation. Thus, it is an essential information in making a financial decision.

However, the person that responsible for preparing the financial report is the manager of the company. Managers might have their personal interest in managing the reported information. Hence, there is a possibility that the reported information does not reflect the actual condition. Thus, before making a decision with the reported information as the base, there is a need to check the reliability of the information first, especially the information of income, which is considered essential information. The quality of the reported income determines the reliability of the information of income. According to Menicucci (2019), a high earnings quality reflects company's current performance. The information can also be used to predict company's future performance and useful to evaluate firm's value. Lipe, Kormendi and Lipe and Richardson in Menicucci (2019) regard persistent earning as high-quality earnings which are stable, permanent and long-lasting.

The quality of the reported income is impacted by a lot of factors. One of them is leverage. Leverage is the utilization of something to attain more than what the company might gain without it. The use of leverage might lead managers to manage the information of income. According to Watts and Zimmerman, Rodriguez-Perez and Van Hemmen and Ronen and Yaari in Hoang and Phung (2019), managers are more likely to manage earnings to obtain favorable contract terms, maintain the creditor-debtor relationship for additional debts and avoid violating the debt contract. Managing the information of income means it does not reflect the actual performance anymore. Therefore, managing the information of income decrease earnings quality.

According to the research conducted by Phuong et al. in 2020, short-term debt impacted earning quality significantly in a negative way, while long-term debt impacted earnings quality positively. According to the research conducted by Ramadan in 2015, leverage had a significant impact on earnings quality. However, according to the research conducted by Fauzi et al., in 2015 and Murniati et al., in 2018, leverage did not impact the quality of the reported income.

The other factor that impacts earnings quality is the investment opportunity set. Investment opportunity set represents company's current investment option. Investment opportunity set is the combination between the asset that the company currently owns and the company's future investment options that are expected to have a positive net present value (Myers, 1977). Investment opportunity set shows company's growth opportunity.

According to Belkaoui (2000), a high investment opportunity set leads to a higher actual or future profitability. However, the regulator might suspect it as an indication of monopoly that will increase company's political risk and cost. A company with a high investment opportunity set might manage and report a lower income to reduce the political risk and cost. However, managing the presented income signifies that the company does not present the real generated income, thus decreasing earnings quality. According to the research conducted by Musa and Aziz in 2018, investment opportunity set has a significant impact on earnings quality. According to the research conducted by Murniati et al., in 2018, investment opportunity set impacted earnings quality. On the other hand, according to the research conducted by Fauzi et al., in 2015, investment opportunity set did not impact earnings quality.

The other earnings quality impacting factor that the writer selects to analyze is accounting conservatism. According to Basu in Khalil et al. (2020), accounting conservatism is an accounting principle that requires the manager to apply a higher degree of verification on recognizing gains and assets than liabilities and losses. According to Watts in Khalil et al. (2020), accounting conservatism prevents managers' opportunistic behavior that maximizes their benefit by managing the reported income. Thus, the application of conservatism increase earnings quality (igi-global.com, n.d). According to Ramadan's research in 2015, accounting conservatism impacted earnings quality. According to the research conducted by Fauzi et al. in 2015, accounting conservatism negatively impacted earnings quality.

Conversely, according to the research conducted by Murniati et al. in 2018, accounting conservatism did not impact earnings quality. According to the research conducted by Ani and Chong in 2021, accounting conservatism had no significant impact on earnings quality.

**Table 1. 1 Leverage, Investment Opportunity Set, Accounting Conservatism and Earnings Quality of some companies at Financial Institution subsector for year 2017-2019.**

Company	Year	Leverage (DAR)	Investment Opportunity Set (MVBA)	Accounting Conservatism (CONACC)	Earnings Quality (ERC)
BPMI	2017	0.60	1.18	(0.08)	(0.88)
	2018	0.58	1.20	(0.02)	0.23
	2019	0.55	1.80	(0.03)	0.47
DEFI	2017	0.01	10.18	0.01	0.13
	2018	0.01	18.60	0.01	(0.01)
	2019	0.01	12.80	(0.18)	0.01
TIFA	2017	0.80	0.92	0.15	(0.08)
	2018	0.77	0.89	0.04	0.07
	2019	0.69	1.05	0.21	1.40

Source: Prepared by writer (2021)

The information of income has a responsive power. Market responses reflect market's perspective on the presented income. Thus, the quality of the presented income can be discerned through market responses. Increasing market responses indicate that the company has a higher earnings quality. Market responses are measured by using Earnings Response Coefficient (ERC).

Based on Table 1.1, from 2017 to 2019, PT Batavia Prosperindo Finance Tbk (BPMI) had a decreasing Debt to Asset Ratio (DAR). In 2017, the debt to asset ratio of BPMI was 0.60 and in 2019, their DAR is 0.55. This indicates that the DAR decrease by nine percent. From 2017 to 2019, BPMI's Unexpected Earnings (UE) fell to a quarter and their Cumulative Abnormal Return (CAR) had doubled.

The responsive market increased the value of the earnings response coefficient from (0.88) to 0.47, indicating that it had increased by 153%. Although BPFI's UE keeps on decreasing, the response that the market gives keeps increasing. The reason might be due to BPFI's decreasing debt ratio that indicates a decreasing financial risk. A decrease in DAR might also reduce creditors' pressure on the management. Hence, it weakens the trigger of managing the presented income. Based on this phenomenon, it can be seen that a decreasing leverage ratio might increase earnings quality.

Based on the table above, from 2017 to 2019, PT Danasupra Erapacific Tbk (DEFI)'s Investment Opportunity Set (IOS) increased and decreased significantly. DEFI's IOS significant increase and decreased might be caused by a significant increase and decreased in its closing price. From 2017 to 2018, DEFI's closing price increased by half. A significant increase in its closing price resulted in a significantly increased investment opportunity set from 10.18 to 18.60. It means the investment opportunity set increased by 83%. DEFI's UE decreased by 183% and its CAR decreased twofold. Thus, it resulted in a decrease of ERC from 0.13 to (0.01), which means it decreased by 109%.

From 2018 to 2019, their closing price decreased by 15%, resulting in a decreasing investment opportunity set by 31%. From 2018 to 2019, DEFI's UE decreases 170% and its CAR decreases sixfold, resulting in an increasing DEFI's ERC by 205%, from (0.01) to 0.01. This signifies that the decrease of DEFI's UE in 2018 is 13% higher than the decrease of DEFI's UE in 2019.



However, DEFI's CAR in 2019 decreased more rapidly than its CAR in 2108, which indicates that the markets were more responsive to the information of income in the year 2019 than in 2018 and results in an increasing ERC. This signifies that the information of income in 2019 has a higher quality. Investment opportunity set shows company's opportunity to grow through the investment option. A company with a high investment opportunity might generate a higher income. However, the regulator might suspect it as the result of monopoly and increase company's political risk and cost. To decrease the political risk and cost, a company might manage and present a lower income that will decrease the earnings quality. Based on this phenomenon, it can be seen that a decreasing IOS might increase earnings quality.

Based on the table above, from 2018 to 2019, PT KDB Tifa Finance Tbk (TIFA) had an increasing conservatism. From 2018 to 2019, TIFA's net income only increased by one-fifth; however, its operating cash flow increased threefold. The huge difference in the increased between TIFA's net income and operating cash flow resulted in the increased conservatism from 0.04 to 0.21, which means it increased 384%. Although TIFA's UE fell by one-tenth, its CAR increased by 55-fold. A responsive market makes TIFA's ERC increased by 2,030%, which is from 0.07 to 1.41. The huge difference between the company's net income and its operating cash flow indicates that the company applies conservatism. Accounting conservatism requires the manager to immediately recognize possible losses and liabilities while postponing the recognition of gains and profit unless it is assured.

Thus, the application of conservatism results in negative accrual, which means increasing negative accruals indicates increasing conservatism. The application of accounting conservatism prevents manager's opportunistic behavior that maximizes their benefit by managing the reported income. Hence, the application of accounting conservatism might increase earnings quality. Based on this phenomenon, it can be seen that when company's conservatism increases, their earnings quality might also increase.

Based on the background, phenomenon and diverse results of previous research, the writer decides to conduct research on earnings quality with the title **“The Impact of Leverage, Investment Opportunity Set and Accounting Conservatism on Earnings Quality of Financial Institution Listed at Indonesia Stock Exchange.”**

## **1.2 Problem Limitation**

This research discusses the factors impacting earnings quality. This research will not discuss all impacting factors and only focus on leverage, investment opportunity set and accounting conservatism as the impacting factors. This research will not be conducted on all companies. This research will only focus on companies listed at financial institution subsector from 2017 to 2019.



### **1.3 Problem Formulation**

Following are the problem formulations of this research:

1. Does leverage significantly impacts the earnings quality of financial institution listed at Indonesia Stock Exchange?
2. Does investment opportunity set significantly impacts the earnings quality of financial institution listed at Indonesia Stock Exchange?
3. Does accounting conservatism significantly impacts the earnings quality of financial institution listed at Indonesia Stock Exchange?
4. Do leverage, investment opportunity set and accounting conservatism significantly impact the earnings quality of financial institution listed at Indonesia Stock Exchange?

### **1.4 Objective of the Research**

Following are the objectives of this research:

1. To determine whether leverage significantly impacts the earnings quality of financial institution listed at Indonesia Stock Exchange.
2. To determine whether investment opportunity set significantly impacts the earnings quality of financial institution listed at Indonesia Stock Exchange.
3. To determine whether accounting conservatism significantly impacts the earnings quality of financial institution listed at Indonesia Stock Exchange.
4. To determine whether leverage, investment opportunity set and accounting conservatism significantly impact the earnings quality of financial institution listed at Indonesia Stock Exchange.

## **1.5 Benefit of the Research**

### **1.5.1 Theoretical Benefit**

#### 1. For Writer

The writer expects to get more insight and a better understanding of leverage, investment opportunity set, accounting conservatism and their impact on earnings quality, especially on companies listed at the financial institution subsector.

#### 2. For Academics

The writer expects to provide deeper insight regarding earnings quality and the impact of the selected independent variable such as leverage, investment opportunity set and accounting conservatism on earnings quality toward companies listed at the financial institution subsector.

### **1.5.2 Practical Benefit**

#### 1. For Firms

Through this research, the writer expects to give a deeper understanding of earnings quality, the selected independent variable and the impact of leverage, investment opportunity set and accounting conservatism on earnings quality that may help entities maximize the quality of the reported earnings.

## 2. For Future Researcher

This research is being expected to be used as sources of reference in conducting research related to leverage, investment opportunity set, accounting conservatism, earnings quality and the selected independent variable's impact on earnings quality.

