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Management Capability To Produce Quality Earning

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ABSTRACT

This research aims at analyze the effects of management ability to earning quality that is measured by restatement, earning persistence, and accrual quality. The objective of this research is to examine how far the capabilities of firm's management can make earning for the firm to become more qualified The research populations were taking from the non-financial reports of companies listed in Indonesia Stock Exchange in the period 2008 until 2016. The sample used for this research are 248 firm or 1.240 observation data which was using purposive sampling method. This research uses panel regression method to analyze the effect of independent variables on the dependent variable. The observation data are analyzed and processed using Statistical Package for the Social Sciences (SPSS) and Eviews 7th version. The result indicates that management ability, independent directors and the total number of directors significant to earning quality that is measured by earning restatement, earning persistence and accrual quality in Indonesia Stock Exchange.

KEYWORDS: Restatement, Eaning Persistence, Accrual Quality, Management Ability

INTRODUCTION

Planning, coordinating and resources controlling process are the basic of management. Organization goal is to obtain as much profit as possible. Thus the ability of managers in managing the company's resources in order to optimize the company's revenue is very important. Manager policies in applying the principles of accounting recording such as income recognition, cost recognition and estimated useful life in the recognition of fixed assets and depreciation methods can effect the quality of the resulting profits. Good earnings quality can reflect actual operational performance through financial statements, and also can be used as a tool in decision making when the income distribution from the perspective of investors (Dechows, Patricia., Weili Ge., 2010).

Management capabilities will make company operation more efficient, especially when making decision in times of crisis. In addition, higher managerial capabilities allow the company for a larger project in scale or performance. During crisis period, a manager's ability is positively associated with the value of the firm to take more loans to invest due to limited funding. Managerial ability can lower financing problems, it will positive correlated to investment automatically. When managers generate higher revenues at the given resource level, or when managerial can minimize the resources used for each level of resources when the manager's ability will be tested. The ability of managers is very influential on the accuracy and relevance of a financial report. Managerial abilities give a significant influence on the accuracy and relevance of a financial report (Baik, Farber, & Le, 2011).

The ability of managers who are better ability to utilize corporate resources well will create a positive impact on the quality of financial reporting. Related research on the quality of financial reporting including earnings estimates also provides strong evidence of the impact of a manager's ability on financial reporting. The earnings quality information is an important information for the investor in decision-making model. Therefore, companies with poor earnings quality may have a higher cost (Francis & Smith, 2005), and receive more attention from securities regulatory agencies. Managers who implement earnings management using discretionary accruals to convert reported earnings figures (Subramanyam, 1996) and (Kasanen, Kinnunen, & Niskanen, 1996) consider why managers want to manipulate discretionary accruals, identify two important issues. First, how do users of financial statements think that discretionary accruals should be interpreted? This is important because discretionary accruals will increase or decrease the value of earnings reporting information. Secondly, legislators also hope that the design and drafting of the guidelines can be reducing the ability of managers to manipulate financial statements (Bernard & Skinner, 1996).

In research on managerial and earnings management skills (Libby & Luft, 1993) more competent managers had a better understanding of the company's economic situation, they could produce better quality financial statement information. The restatement of financial statements often involves the negligence of material accounting or misstatement in a financial statement. The productive increase in restatement over the last decade raises questions about the quality of accounting reports (Palmrose & Scholz, 2000). The misstatement of the financial statements will be a question of the quality of the resulting report, thus raising questions about the manager's performance in reporting the misstated financial statements.

Companies that are restatement to net income, Demonstrate the ability of a manager in managing resources owned by the company. The ability of a manager will have high impact

if the quality of the resources owned by the company is good and secure and the flexibility of access owned by a manager in utilizing existing resources. It gives a little help to managers in managing the company so managers do not have to exert all their strengths, but in practice the resources provided by the company sometimes have poor quality. In the end, managers must mobilize their ability to process or use these resources efficiently and effectively. The ability of managers in managing the work of the workers about what to fit their abilities. The goal is to make sure the resources are used in an efficient and effective manner. The result is expected to minimize the restatement of net income in a company.

Profit persistence describes the ability of current earnings sustainability in the future. (Francis & Smith, 2005) Persistent earnings will show future earnings relationships with current accruals and cash flows. Managerial skills influence earnings persistence when the managerial skills of a company manager are capable of creating a stable and sustainable corporate earnings in the future. The existence of good operational capabilities of managers can minimize the decline in the number of profits or losses. Because, manager's ability will be able to take advantage of resources owned by the company and create opportunities to earn revenue through both current and future production. Thus, the less likely incidence of decline in future profit.

High earnings quality can be expressed with sustainable profit persistence; while for poor earnings quality can be expressed with unusual earnings persistence (Penman & Zhang, 2002). From the above statement it can be assumed that, the consistency of a profit generated can show the consistency of the performance of corporate managers. Where there is a high relationship between the ability of managers with profit persistence, if the resulting profits are sustainable then the level of managerial ability to positively related if the profit persistence produced is unusual then vice versa.

(Choirina & Ahmar, 2013) skills or ability of managers to generate profits with efficient use of company resources manifested through capital and employment investment decisions, revenue-generating activities, and efforts to minimize costs can affect the persistence of earnings. Therefore, managers with high managerial skills will be more effective and efficient in implementing operating decisions both to create current cash flow and accrual accuracy in describing future cash flow. (Demerjian, Lev, Lewis, & McVay, 2013) shows that there is a positive and significant relationship between managerial skills and profit persistence. This is because the more competent managers, they will be better in choosing business projects, better understand the possibilities of risks faced by the company, and able to manage the company more efficiently. So as to maintain profits and make sustain profit consistently every year.

Accrual is the amount of accounting adjustment that makes net income different from net cash flow. This adjustment includes adjustments that affect earnings when there is no impact of cash flows (eg credit sales) and adjustments that impact the cash flows on earnings (eg, asset purchases) (Subramanyam, 1996). Accrual adjustments are recorded after making reasonable assumptions and estimates without compromising the reliability of material information. It takes a qualified manager to estimate accruals, because every decision taken will provide different value information. The existence of uncertainty relating to accruals demands high managerial skills over any judgment given for each estimate made. So there is no noise in the profit.

Limitations possessed by the management in a company allows in the process of determining calculations, estimates, assumptions and certain accounting policies there are errors. However, such freedom is feared will be misused by the management in

manipulating the earnings or commonly referred to as earning management dikarenakan existence of motives owned by the management. The accrual rate will be inversely proportional to the quality of profit, because the higher this level, the quality of profits will be reduced. Due to the level of accrual that is inversely proportional to the quality of profit, it can be concluded that the higher the level of accruals so the quality of the resulting profits will be lower, lower earnings quality will affect straight with the ability of management.

Individual ability and capability of a person is an important factor in determining its success. Ability to organize and become a leader not only obtained from education. On the contrary, that character should be already inside everyone. The ability of managers can be interpreted as a capability and efficiency in leading an organization in achieving the goal by using existing resources. If the resources provided are qualified and can be freely accessible to the manager, then the manager's capability are important. The fact is that most of the resources provided are less qualified, as well as the facilities provided, so here the manager strives hard to maximize his ability. Managerial capability is needed to build itself, depending on the function and activity, when needed to make the right and accurate decisions as much as possible with regard to existing conditions. In this way, it will be able to meet the needs of the organization in the long run and take effective action in realizing its objectives.

Over the last three decades, the quality of earnings has attracted the interest of researchers, and several attempts have been made to achieve reasonable and valid methods for evaluating earnings quality and identifying factors affecting it (Bhattacharya, Desai, & Venkataraman, 2013). Earning quality can be divided into three categories: profit persistence, accrual rate, and earnings restatement. The restatement of financial statements often involves the negligence of material accounting or misstatement in the period before the financial statements. The productive increase of restatement over the past decade raises questions about the quality of accounting reports (Palmrose & Scholz, 2000). For example, (Eilifsen & Jr, 2014) identify four conditions that must exist for the audited financial statements: (1) material misstatement occurs as a result of inherent risks such as aggressive management accounting practices or errors of GAAP, (2) misstatements undocumented or prevented by internal control of the company; (3) the external auditor fails to discern misstatements and financial statements before they are issued; (4) misstatements that are later discovered and, if material, require correction, restatement and exclusion from the financial statements . The third condition will cause fraudulent financial statements. (Kinney & McDaniel, 1989) examined 73 companies for a report from 1976 to 1985. They found that companies in small size, small profits but with higher debt and uncertainty. (DeFond & Jiambalvo, 1991) rated 41 companies in poor financial condition restated with the 1977-1988 report, found that there was a correlation between profit error and the manager's response to incentive compensation.

Profit that can be used as an indicator of future earnings is the notion of profit persistence. Understanding of earnings persistence according to (Penman & Zhang, 2002) which explains that high quality profits are expressed with sustainable profit persistence; otherwise if the unusual profit is expressed as a profit that has poor quality. Penman (2003) differentiates earnings into two groups: sustainable earnings (earnings persistent or core earnings), and unusual earnings or transitory earnings. Persistence profit is a profit that has the ability as an indicator of future earnings generated by the company repetitive (long term) (sustainable). While unusual earnings or transitory earnings are temporarily generated

79 profits and cannot be repeatedly generated (non-repeating), so they cannot be used as indicators of future period earnings.

Research Hypothesis

Accrual-based accounting is one of the basic assumptions in the preparation of financial statements. Accrual based accounting means the recording of a company's financial transactions is when the transaction occurs and not only when the transaction involves the expenditure or cash and cash equivalents. For example revenue already can be recognized when the possibility of future profits is acceptable or can be measured reliably (Revenue Recognition), as well as the burden already can be recognized at the time so not only when the cash cash (Expense Matching). The delicacy of management in accrual selection can cause distortions in the usability and quality of earnings.

Certain limitations owned by the management company in determining the accrual would cause mistake (calculation) and selection of estimates, assumptions, and accounting policies. As for the flexibility of the management to determine the policy is also feared deliberately used to manipulate earnings (earnings management) because of certain motives and incentives from the management. (Easley & Hara, 2001) argued that the accounting treatment of firms on earnings and disclosure can affect the enterprise information environment which will impact on information risk, idiosyncratic volatility, and cost of capital. Thus the accrual rate will be inversely proportional to the quality of profit, because the higher this level, then the quality of profits will be reduced. Based on previous research statement above, the hypothesis was summarised as follow :

H₁ : Manager ability will impact significantly toward earning restatement.

H₂ : Manager ability will impact significantly toward earning persistence.

H₃ : Manager ability will impact significantly toward enhancing accrual quality

METHOD

This was categorized as quantitative research because it was a theory of measure toward research variable which was number. This research is categorized as quantitative research because it emphasizes the theory testing through measurement of research variables in the form of numbers. This research in terms of research objectives is basic research that aims to develop and evaluate theoretical concepts. So that it is expected to contribute to the development of theory. Based on the characteristics of the problem, this study is categorized as historical research and correlation. Historical research is because this research problem is related to the past (historical) to explain current phenomena with the aim of anticipating future phenomena. Correlation research that involves the act of collecting data to determine whether there is a relationship and the degree of relationship between two or more variables.

The data testing in this study will be processed using Statistical Package for Social Science (SPSS) version 21 program to test outliers and obtain descriptive statistics and Eviews version 7 program to test the best model selection, F test, test coefficient of determination and T to test the hypothesis of this study.

Companies listed on the Indonesia Stock Exchange are 559 companies, where there is one control variable that is Earning Volatility which uses Standard Deviation with 3 years Earnings backward, and there is one dependent variable which is Earning Persistences using Cash Flow From Operation Coming Year number, data of the company year that can be taken is from 2008-2016. Companies registered from 2008 and above cannot be

sampled by research, so based on the sorting results there are 248 companies selected as sample of this research.

Dependent Variable: Measuring Earning Quality

Earning Restatement

Measurement of earnings restatement is done by giving score 1 for companies that perform restatement of financial statements and 0 to vice versa. Then to rasionya seen from how much influence between number restatement observation with total number of observation at each company.

$$E \text{ Restatement} = \text{Oberservations with restatement of earning} / \text{total observations.}$$

Earning Persistences

Earning persistences will be used in the estimation of the third model. Where if there is a high correlation between the current year profit with future profit, it will be more stable profit of the current year generated.

$$\text{Earning } I_{t+1} = a_0 + a_1 \text{ Earnings } I_t + e_{it}$$

Accrual Quality

The third measurement of earning quality is by measuring the quality of accruals.

$$CFO_{i,t+1} = a_0 + a_1 \text{Accruals}_{i,t} + e_{it}$$

Accrual equals the difference between net income and operating cash flows, can be calculated by the following equation:

$$\text{Accruals} = \text{Earnings} - \text{CFO}$$

Management Ability

Efficiency is one of the indicators used to measure management ability, by looking at how many resources are used to produce an output. The higher this ratio the higher the efficiency. where GOGS, SAExp, INV, PPE, IntngA are cost of goods sold, selling and administrative expenses, inventories, net fixed assets, and intangible assets. Contol Variable consist of :

1. Firm size : Log Total Asset
2. Earning Volatility : Standard deviation of three years earning
3. Cash Flow From Operations: Operating Cash Flow / Total Assets
4. Operating Cycle : $WC = 360 / (\text{Sales} / \text{Average AR}) + 360 / (\text{COGS} / \text{Average Inventory})$
5. Loss : Companies experiencng losses in the current year will be given numbers 1 and 0 for the contrary.
6. Auditor Quality : Companies audited by the big 4 Auditor Firm in the current year will be given numbers 1 and 0 for vice versa.
7. Change in Sales Revenue
8. Return On Assets

RESULTS AND DISCUSSION

Based on the Table 1, the significant value for the variable of Earning Quality as measured by Earning Restatement, Earning Persistence and Accrual Quality is 0,0000, showing result smaller than 0,05, indicates that variable ability of manager. Simultaneously significant effect on Earning Quality. The regression result is served in Table 1 below:

Table 1.
Regression
Result

DV	F	Sig.	Conclusion
Restatement	967.031	0,0000	Model Accepted
Earning Persistences	48.3013	0,0000	Model Accepted
Accrual Quality	170.052	0,0000	Model Accepted

Thus, the regression model in this study can be used to predict the variable of Earning Quality as measured by Earning Restatement, Earning Persistences and Accrual Quality. From the result of T Test we got the following regression

$$\text{Earning Restatement} = -0.007315 - 0.05678\text{MGRABILITY} + 1-0.975891$$

H1 : Manager ability are more likely to extreme enhancing earning restatement.

The results of this study indicate that Managerial Ability variable has a significant negative impact on Earning Quality as measured by using Earning Restatement. This indicates that firms with high levels of managerial ability which are measured through Firm Efficiency will be lower for restatement of financial statements in the net income section this indicates of the more efficient of a firm, the probability rate of earning restatement will be lower because a good management will have the capability to manage their resource efficiently and effectively so the possibility of error will be lower because he ability of managers is very influential on the accuracy and relevance of a financial report. Managerial abilities give a significant influence on the accuracy and relevance of a financial report (Baik et al., 2011). The ability of managers who are better ability to utilize corporate resources well will create a positive impact on the quality of financial reporting. managers must mobilize their ability to process or use these resources efficiently and effectively. The ability of managers in managing the work of the workers about what to fit their abilities. The goal is to make sure the resources are used in an efficient and effective manner. The result is expected to minimize the restatement of net income in a company.

From the result of t-test we got the following regression

$$\text{Earning Persistences} = 4.358355 - 1.320851 + 1 - 0.907382$$

H2 : Manager ability are more likely to extreme enhancing earning persistence.

The results of this study indicate that the ability of managers have a significant negative effect on Earning Persistences, which means the higher the ability of the manager the lower the level of stability of the company's earnings. But the ability of this manager is very influential in determining profit stability. This is very provable because in the efficiency and effectiveness of the company's resources although the manager's ability is high in the management of resources, so as to increase efficiency and effectiveness, profit generated by the company wont be stable, because there are influences such as the deterioration of the world economy and the business definitions. Managerial skills influence earnings persistence when the managerial skills of a company manager are capable of creating a stable and sustainable corporate earnings in the future. High earnings quality can be expressed with sustainable profit persistence; while for poor earnings quality can be expressed with unusual earnings persistence (Penman & Zhang, 2002).

Table 2 below is served about determination coefficient result:

Variabel Depend	Adjusted R square
Earning Restatement	0.975891
Earning Persistences	0.907382
Accrual Quality	0.972233

Table 2.
Determinantion
Coefficient
Result

From the result of T Test we got the following regression

$$\text{Accrual Quality} = 1.588649 - 0.012607 + 1 - 0.972233$$

H3 : Manager ability are more likely to extreme enhancing accrual quality.

The results of this study indicate that the ability of managers have a significant negative impact on Accrual Quality, which means the higher the ability of the manager, the lower the accrual quality of the company. This proves that the ability of a manager can determine the quality of accruals generated, because the higher level of a manager's ability will affect the level of accounting system estimates in making quality policies.

Accrual is the amount of accounting adjustment that makes net income different from net cash flow. This adjustment includes adjustments that affect earnings when there is no impact of cash flows (eg credit sales) and adjustments that impact the cash flows on earnings (eg, asset purchases). Accrual adjustments are recorded after making reasonable assumptions and estimates without compromising the reliability of material information (Subramanyam, 1996). It takes a qualified manager to estimate accruals, because every decision taken will provide different value information. The existence of uncertainty relating to accruals demands high managerial skills over any judgment given for each estimate made. So there is no noise in the profit. The result of the determination coefficient test (adjusted R2) for the panel regression model using independent variable managerial ability, independent board, and board size to earning quality as measured by earning restatement, earning persistence and accrual quality.

CONCLUSION

Based on the results of testing and analysis, this study aims to determine the effect of independent variables on the dependent variable as measured by Earning Quality. Based on the analysis and discussion in the previous chapter can be concluded that an independent board of management abilities and significant negative effect on earnings quality by measurement of earnings restatements for the board size while positive significant effect on earnings quality with earning statements as measurement. Management Abilities significant negative effect on earnings quality by measuring earnings persistences while an independent board and board size positive significant effect on earnings quality by measurement persistences earnings. Independent board of management abilities and significant negative effect on earnings quality by measuring the quality accrual board size while positive significant effect on earnings quality with accrual measurement quality.

Recommendations for future research are adding independent or other dependent variables that have a stronger influence in generating better research models. Such as independent variables Managerial Ability that can be applied to financial companies and non-financial. In order to expand data sampling, subsequent research can share companies based on industry type. thus it will produce more effective results. Meanwhile, by increasing the measurement of earning quality such as earning predictability and earning informativeness used in the research of (Ahmed Al-Dhamari & Ku Ismail, 2015)

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