Corporate Governance and Financial Statement Quality – Evidence from Cooperatives Institutions in Indonesia

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Abstract. This research aims at examining the effect of corporate governance mechanism, income volatility, ROA, ROE, size, liability and leverage to the quality of financial statements. The object of this research was cooperatives in Semarang city, Central Java, as many as 176 cooperatives. The sample was determined by purposive sampling methods. The analysis of hypothesis acceptance used was multiple regression analysis with the significance level of 10%. The results showed that GCG mechanism measured by the supervisory board's educational background had a significant effect on the quality of financial statements. Besides, the volatility, ROA, ROE, size, and leverage also have a significant influence on the quality of financial statements. Meanwhile, liquidity does not have any significant effect on the quality of financial statements.

Keywords: Financial statement quality; Good Corporate Governance; Cooperatives Institution

1 Introduction

Since Indonesia is still experiencing poverty problems. Indonesian Central Bureau Statistics (BPS) data shows that the number and percentage of the poverty are as follows:

Tab1e 1. Data of Poverty in Indonesia (Million)

Profile of the Poor	March 2016		March 2015		March 2014	
	Amount	%	Amount	%	Amount	%
Rural	17,67	63,08%	17,89	62,75%	17,94	62,75%
City	10,34	36,92%	10,62	37,25%	10,65	37,25%
Total	28,01	100%	28,51	100%	28,59	100%

Source: Serikat Petani Indonesia (SPI)

Table 1 above shows that based on the number, there has been a decrease in poverty. However, if based on the poverty profile, the poor people from rural communities experienced an increase from 62.75% in March 2015 to 63.08% in March 2016. One of institutions that can

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reduce poverty is microfinance institutions [1] [4]. A kind of microfinance institution in Indonesia is cooperative. These means that the existence of cooperatives could reduce the number of poverty [5] [6].

The strategic role of cooperatives to reduce poverty could not be implemented properly. This statement is evidenced by the number of cooperatives that went bankrupt. According to the Assistant Deputy for Marketing Facilities and Infrastructure, the Ministry of Cooperatives and Small and Medium Enterprises of the Republic of Indonesia said that Indonesia had 280,000 cooperative units and as many as 70,000 cooperatives had gone bankrupt. Thus, the percentage of 35% is inactive cooperatives. Moreover, the minister said that 60.000 cooperatives in Indonesia whose conditions are not healthy [7].

Economic factors and the regulatory support affect the viability of microfinance institutions. Other expect said that supervisory from the government will ensure the microfinance institutions to be more cautious, and has effect to reducing fraud. The lack of government supervision give impact the microfinance institutions to have higher risk [8]. In addition, the constraints experienced by microfinance institutions are the lack of supervision from the government [9].

The efforts to improve supervision is by improve the accountability of cooperatives through the publication of financial statements for stakeholders. Microfinance institutions have not fully published their financial statements widely, so that the control from stakeholders is minimal. Furthermore, the condition has potentially to increase misuse of management which will further affect the decline in business continuity. Microfinance institutions that already are not fully publicized properly, so that the control of all stakeholders becomes minimal and the potential for misuse of management becomes big and will further impact on the decrease of business continuity.

Furthermore, improving the quality of financial reports can also be used to improve supervision. The enhancement of financial statements quality has impact on better monitoring system and implementation of corporate governance [10], [11], [12], [13]. Other researcher used financial indicator to predict financial statement quality [14]. The quality of financial statements is important as it can reduce the asymmetry of financial statements. Likewise, high quality of financial statement will improve the quality of decisions taken by investors. The quality of financial reports will produce a qualified information as well.

Based on the phenomenon shows that the sustainability of cooperative enterprises is low. It is necessary to conduct research to describe the problem of the low sustainability of cooperatives in Indonesia. This study was carried out to evaluate the quality of financial statements of cooperatives and to prove empirically on the factors that influence it. This is because the quality of financial statements, will result in the evaluation of qualified stakeholders as well.

Theoretical Framework

a. Agency Theory and Agency Problems at Cooperatives Institution

Indonesian Law number 25 Year 1992 on Cooperatives states that the cooperative is a business that consists of people or cooperative legal entity with the base of its activities in accordance with the principle of cooperatives as well as people's economic movement which is based on kinship principle. Cooperative is also called as an economic movement of societies. Then, chapter 5 states that cooperative principles for its members are voluntary and open. The management is democratic, and the profit is shared equitably based on the members' roles and activities.

The cooperative management is carried out by the cooperative boards and supervisors which are selected by cooperatives members at a annual member meeting. In chapter 24, paragraph 3, it is stated that all members have one vote in the member meetings. It means that the votes obtained by members are not based on the amount of capital given to the cooperatives. The next question is will there be agency if the cooperative management is based on cooperative principle?

Agency relations as a contract which doing between the owner (called a principal) and the manager (called an agent) [15]. Then, the principal entrusts the company to the agent. The agent is given rights by the principle to determine company policies that are beneficial for the company. This is because the principal is very interested in developing company. The concept of authority delegation is usually found in large companies.

In addition, a company's operations which are so broad, and a number of shareholders encourage the company to give a response to the boards of director to manage the company. Subsequently, the agency relationship extended into the SMEs company has made the separation of authority between the owner of the company and the manager. However, in line with the increasing diversity of company operations, this delegation of authority also occurs in individual companies [16].

Unlike companies in general, cooperatives are unique companies. The uniqueness of cooperatives is all the parties involved in the cooperative is considered as the owners. It is in accordance with the Indonesian Law number 25 Year 1992 on Cooperatives. It states that a cooperative is a business run by people or cooperatives legal entity. Its activities are based on the principle of cooperative and kinship. Then, cooperatives can be said as people's economic movement. Furthermore, chapter 4 states that the cooperative aims at promoting the welfare of members in particular, and society in general and to support the national economy in order to realize a developed and prosperous society based on Pancasila and the 1945 Constitution of the Republic of Indonesia.

b. Quality of Financial Statement

The agency conflict between the management and owner is manifested in the form of information asymmetry. In fact, it requires efforts to reduce it. Then, a solution to decrease the information asymmetry is financial statements [17]. A financial statement is a communication information between managers and stakeholders [18] [19]. The purpose of the financial statements is to produce a qualified information of financial statements, include the corporate economy and finance used for economic decisions. High quality financial statement is essential as it will increase capital, and other stakeholders in investment decision making, credit, and resource allocation decisions that will improve market efficiency.

Some researchers, such as [20] and [21] disclosed that the quality of financial statements with indirect measurement are focused on earnings management, remaking of financial statement, and on time publication of financial statement. [22] used variables of earnings quality, conservation, and accrual quality should be added at measuring the quality of financial statements. The existence of earnings management in the company indicates that the quality of financial statements is low.

Meanwhile, [21] stated that the measurement of profit quality can be seen from the different perspectives, such as earnings persistence, predictability of future performance, earnings variability, and the relationship between cash, accrual and income. [17] and [23] tried to measures the quality of earnings from accrual measurement. Meanwhile, [21] used the disclosure of financial statements as the quality of financial statements.

Different with the previous measurement, some researchers have developed a measurement of quality of financial information based on economic theory. The economic theory that assumes ceteris paribus can improve the quality of financial statements will have an impact on the decline on information asymmetry and will further reduce the cost of capital [21].

Based on above discussion, there is an indirect and positive relationship between the quality of disclosure and capital market valuation [23].

c. Previous Studies

According to the various studies developed the measurement of financial statements quality, there are at least three models. The first approach is the factors that influence the financial statements based on the company's financial analysis. These factors are dynamic innate factors (operating cycle, sales volatility), static factors (firm size, firm age), firm performance (proportion of loss), institutional risk (liquidity, leverage), environmental risk (industry classification) [23].

The second approach is measuring the quality of financial statements in regard to the response of investors as the users of financial statements presented in the capital market. This is in relation to the view that the availability of financial statements will reduce information asymmetry. The third approach is the profit quality measurement approach based on the quality of management organization performance as measured by the implementation of good corporate governance (GCG) compliance. Measuring the quality of good corporate governance implementation based on GCG mechanism. This is based on the view that GCG implementation will have an impact on performance improvement which further improves the quality of financial statements [10].

Some researchers have described many factors that affect financial statements. One factor is the structure of the board [17]. The emergence of financial statements due to agency conflicts between managers and owners. The structure of the board has a function to reduce the information asymmetry between manager and owner. [24] stated that the board structure can improve the quality of financial statements. It is because the board of directors has the task of improving the transparency of financial statements [17].

The implementation of corporate governance in predicting the quality of financial statements [24]. The assumption used is the level of corporate governance will improve the quality of financial statement information. Here, the operationalization of corporate governance can enhance the supervision of management operations, so the management performance is supervised. Then, a qualified financial report will be well presented.

Slightly difference with the previous research, this research focuses on cooperative as the object of study. Based on several researchers who developed the measurement of the quality of financial statements and the influential factors development, there are some measurements which are problematic to be implemented in cooperatives. Unfortunately, this includes SMEs as they have different management models.

d. Theoretical Framework and Hypothesis

This research different approaches that previous research. This research is conducted by combining the first approach emphasizes on financial factors and the third approach, emphasizes on GCG mechanism factors. Then, the object of the study is cooperatives with their own uniqueness, because all consumers in cooperatives are member and the member is owners. In fact, some researchers used GCG mechanism. This becomes one of the factors affecting the quality of financial statements [25]. The mechanism uses the ownership structure.

Furthermore, it has been proven empirically affects the disclosure of financial statements. [11] found that there is not any significant relationship between family ownership, state ownership, and institutional ownership to the quality of financial statements. Similar findings were also find by [26], [27], and [28] argued that there is a positive relationship between GCG mechanisms measured by the commissioners, audit committees and internal auditors, and the quality of financial statements. In reference to some previous studies, GCG research is focused more on large companies, and it has not been applied on small companies yet, such as cooperatives.

Moreover, the GCG mechanism that will be applied on small companies should be adjusted. This is because small and large companies have different characteristics. Some of the measurements used as a representation of GCG mechanisms implemented in small companies are the number of supervisory boards and supervisors' educational backgrounds, so that the hypothesis can be developed as follows:

H1: GCG mechanism (number of supervisory board and supervisors' educational background) influences financial statements quality.

Some researchers have used a measurement of the company's financial performance in predicting the quality of financial statements such as [22]. The company performance can be measured by implementing ROA and ROE. Some researchers, such as [23] used volatility opinion measurement to measure a performance in the long run. More specifically, higher earnings quality is associated with lower firm-specific return volatility [29] and earning management related with financial statement quality [30].

Thus, the hypothesis that can be developed is:

H2: Income volatility influences financial statements quality.

Proved that there is a negative relationship between the performance of the company and the quality of financial statements. The company's performance measurements used are ROA and ROE. The results of this study support the research of Chan et al., (2004). He stated that companies with good quality financial statements will cause a decline in company performance for the future period (Chan et al, 2004). The causality relationship between disclose as an indicator of the quality of financial statements and the firm performance has been studied by [31]. Thus, the hypothesis that can be developed is:

H3: Profitability (ROA and ROE) influences financial statement quality.

The use of company's financial ratio or condition as a factor for determining the quality of financial statements was studied by [32]. They found a significant influence between the level of leverage and liquidity, and asset structure to the quality of financial statements. Another indicator was used by [14] [14], they found that there is a positive and significant effect between firm size and leverage level to the quality of financial statements.

H4: The size influences financial statements quality

H5: Liquidity influences financial statements quality

H6: Leverage influences on financial statements quality

H7: GCG mechanism, income volatility, ROA, ROE, cooperative measurement, liquidity and leverage influences financial statements quality

2 Research Methods

The objects of this research were cooperative institution (a kind of microfinance in Indonesia) in Semarang district, Indonesia. Cooperative was chosen because have big asset, so it needed more supervision. In addition, Cooperative's businesses were mostly in the saving and loan businesses had greater risk. The sample was determined by purposive sampling method with the criteria: the cooperative had complete financial statement from 2010 to 2016. The data used in this research were primary and secondary data. The primary data were taken from questionnaires given to cooperative managers.

Here, the questionnaires were related to the implementation of GCG mechanisms. Then, the secondary data were obtained from the financial statements to determine the financial ratios and quality of financial statements.

The variables used in this research were written as follows:

a. Financial statements quality measured with the indicator of relevance, faithful, representation, comprehension of management toward accounting standard, comparability, and timelines. These indicators were measured by a questionnaire approach. The measurement of financial statement quality refer [13]'s research. This method is used because the object of research in this study is cooperatives that still have limitations in reporting financial statements [33], [34]
b. GCG mechanisms are measured based on the size and supervisory educational background. Score 1 is given when the supervisor has a background in accounting and finance education. A zero score is given when the supervisor has a background other than accounting and finance.
c. Income volatility was measured from the income for 5 years divided by total assets for 5 years as well. This variable was used to measure the spread of income or the distribution of income distribution index. The operational use of this variables was modified from the views of [23].
d. Profitability was measured by using Return on Assets (ROA) and Return on Equity (ROE)
e. Size was measured with total assets
f. Liquidity was measured with the percentage of current assets divided by all assets [32].
g. Leverage is measured using the total debt formula in year t divided by the total assets of the firm in the same year [35].

Hypothesis was accepted if the significance level was less than 0.10. Data analysis used in this research is descriptive analysis. In addition, there will be related causality test whether there is the relationship between implementation variables governance performance of the cooperative. Both of those variables had a ratio data, so the testing tool used was regression analysis. The hypothesis is accepted at a significance level of less than 0.10..

3 Results and Discussion

The results of descriptive analysis consisting of minimum score, mean and standard deviation of data from each variable used are as follows :

Table 2. Descriptive statistics

	N	Min.	Max.	Mean	Std. Deviation
Quality	176	,20	,90	,6168	,16729
Supervisory Size	176	3,00	3,00	3,00	,00000
Education background	176	,00	3,00	,4943	,77088
Income volatility	176	,02	,99	,4342	,24052
ROA	176	,01	,12	,0548	,03349
ROE	176	,02	,39	,1074	,07878
SIZE	176	369.180.008	86.043.484.712	8.723.273.769	18.192.627.282
Liquidity	176	1,34	15,33	3,8932	3,03131
Leverage	176	,13	,83	,4429	,18623
Valid N (listwise)	176				

Hypothesis testing is done using partial and simultaneous hypothesis test. Then, partial test is carried out by looking partially at the significance score of each variable. The table below is the test results:

Table 3. Coefficient

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	,678	,051		13,233	,000
BACKGRND	,065	,015	-,301	-4,237	,000
VOLABLTS	,190	,055	,273	3,468	,001
ROA	2,158	,654	-,432	-3,300	,001
ROE	,858	,306	,404	2,799	,006
SIZE	1,852E-012	,000	-,191	-2,693	,008
LIQ	,001	,004	-,020	-,281	,779
LEV	,149	,085	-,166	-1,742	,083

Based on table 3, some variables have a significance score greater than 0.05. Some variables that have significance score less than 0.05 are background of supervision, volatility, ROA, ROE, and Size. The variables that have significance score from 0.05 to 0.10 are leverage, and variables that have a significance score above 0.10 are liquidity.

Furthermore, the governance variables are measured by supervisory board's educational background. It is yielded a significance score of 0.000. This indicates that the supervisor education background has a significant influence to the quality of financial statements.

The volatility income variable of cooperatives which is measured by Volatility variable has obtained a significance value of 0.001. This significance value is lower than 0.05. This indicates that the volatility of the cooperative's earnings has a significant influence (with a significance level of 5%) to the quality of the financial statements.

The third variable is Profitability measured by using Return On Assets (ROA) and Return On Equity (ROE). The research findings show that the significance value of ROE is 0.008 and the significance value of ROA is 0.001. This indicates that the ROA and ROE variables have a significant influence to the quality of cooperative financial statements. The fourth variable is the size of the cooperative measured by the number of cooperative assets (Size). Table 3 shows a significance value of 0.008. These findings indicate that size has affects the quality of financial statements.

The fifth variable is the level of liquidity. This variable has a significance value of 0.779. The value of this significance is greater than 0.10. This means that the level of liquidity does not have any significant effect to the quality of financial statements. The sixth variable is the leverage variable. Partially, the test results yields a significance score of 0.083. The value of this significance is below 0.10. This points out that at a significance level of 10%, leverage variable has a significant influence to the quality of financial statements.

Moreover, the simultaneous analysis is conducted to test all independent variables (the supervisory board's educational background, income volatility, ROA, ROE, cooperative measure, liquidity and leverage) to the dependent variables (quality of financial statements). Then, it yields a significance score of 0.000. This significance score is below 0.05. It also identifies simultaneously that at a 5% significance level, the supervisory board's educational background, income volatility, ROA, ROE, cooperative measure, liquidity and leverage have a significant influence to the quality of financial statements.

Based on the above analysis, the acceptance and rejection of the hypothesis can be seen at the following table:

Table 4. The Result of Hypothesis Testing

No	Hypothesis	Sign.	Conclusion
1	Ha_1: GCG mechanism influences the financial statements quality	,000	Ha is accepted
2	Ha_2: Income volatility influences the financial statements quality	,001	Ha is accepted
3	Ha_3: Profitability (ROA and ROE) influences the financial statements quality	ROA : ,001 ROE : ,006	Ha is accepted
4	Ha_4: Size influences the financial statements quality	,008	Ha is accepted
5	Ha_5: Liquidity influences the financial statements quality	,779	Ha is rejected
6	Ha_6: Leverage influences the financial statements quality	,083	Ha is accepted
7	GCG mechanism, income volatility, ROA, ROE, size, liquidity and leverage influences on the financial statements quality	,000	Ha is accepted

The findings show that GCG mechanism has a positive and significant effect to the quality of financial statements. Then, it strengthens the findings of [27], [13] and [27]. However, it rejects the findings of [11]. The variables of GCG mechanism used in this study focus on educational background of supervisor. Thus, the supervisor who have accounting background can produce more qualified financial statements than others. Supervisor in cooperative institution has same obligation with board of commissioner. Supervisor as same board of commissioner as has a task to monitoring toward management or directors to manage cooperatives resources. The active role of the supervisory board in the operationalization of the cooperative greatly affects the improvement of performance and subsequently has a impact on the better performance of cooperatives.

The second finding illustrates that the income volatility has a positive and significant impact to the quality of financial statements. The income volatility that measures a constant long-term revenue will have an impact on disclosure improvement and will subsequently have an impact on improving the quality of the financial statements. Cooperative that has high income volatility has a tendency to improve the quality of financial statements through the addition of financial information. This effort to convince the stakeholders that the company has a better performance. Despite the view that stable enterprise business has a tendency to be chosen by stakeholders because the company has an good image as both secure and low risk.

The profitability was measured by ROA and ROE finds that ROE and ROA have a positive influence to the quality of financial statements. This means that the increase of profitability in the current year will be followed by the improvement of the quality of financial statements through the increased disclosure. Increased profitability of cooperatives will be followed by the addition of financial information. This effort is made to enhance stakeholders' trust. This finding then supports the finding of [31].

The size of the cooperative measured cooperative assets has a positive and significant impact to the quality of financial statements. The more assets the cooperatives have, the wider information presented in the financial statements will be. It is because of the amount of funds managed are in a great number, so the disclosure presented will be more complex. Large companies tend to have more stakeholders. Increasing stakeholders have impacts on information demand. This condition will be followed by an increase in financial information. In this case, the study supports the findings of [31] and [14]. [27] used corporate accrual as measurement of financial statement quality and showed that size has impact on corporate accrual.

Leverage levels are also proven to be statistically affecting the quality of financial statements. High leverage requires transparency in presenting the financial information, so it will improve the quality of financial statements. It is necessarily needed, especially for investor as a basis for analyzing the security of funds invested at cooperatives. Improvement financial statements quality would enhance performance and has impact increase investor’s trust. These findings is supporting the findings of [32] and [14].

The liquidity has not affect the quality of financial statements. It is mean that the level of liquidity is not one of the factors that can improve the quality of financial statements. The assumption developed in this hypothesis is the cooperatives which has low liquidity will be responded by improving the quality of financial statements is not proven in this study, thus this study rejects the research conducted by [32].

4 Conclusion

The results show that the quality of financial statements is simultaneously influenced by GCG mechanism, income volatility, profitability (ROA and ROE), size, liquidity and leverage. In addition, partially, the quality of financial statements is influenced by the following points:

a. GCG mechanism has a positive influence on financial statements quality. Then, Cooperative supervisor who has educational background in accounting has a significant influence on the quality of financial statements.
b. The income volatility has a positive effect to the quality of financial statements. The more consistent long-term revenue will be followed by the improvement of financial statements quality.
c. Profitability (ROA and ROE) have a positive influence to the quality of financial statements.
d. The size of cooperative also has positive influence to the quality of financial statements. The cooperatives which have large asset would to increase their disclosure in the financial statements, thereby impacting on improving the quality of financial statements.
e. Cooperatives which have high leverage tend to increase the disclosure. The cooperatives provide broader financial information for investor and has impact on increasing the sustainability of credit gained by the cooperative.

The weakness of this research is the use of GCG mechanism variables that are only measured the supervisory board's educational background. Therefore, the analysis of the number of supervisory board members cannot be done, because based on the data obtained, the cooperatives as research samples has three-person supervisory board. Hence, it is expected that the next researcher develops other variables to measure the GCG mechanism which is in accordance with the characteristics of the cooperative institution.

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