

## **Financial Reporting Quality of the Manufacturing Firms Listed in Indonesian Stock Exchange**

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### **Abstract**

The purpose of the study is to empirically investigate the financial reporting quality of listed manufacturing firms in Indonesian Stock Exchange. The study has collected 287 responses from the financial officers and experts of 89 IDX-listed manufacturing firms using a five-point Likert scale instrument based on the nonprobability purposive sampling technique. The study has employed PLS-SEM using SmartPLS version 3.2.8 for data analysis. The results have shown that hypothesis-1 postulating that CSR has significantly positive effect on financial reporting quality has been accepted while hypothesis-2 suggesting that environmental performance has a significant and positive effect on financial reporting quality. The managers are recommended to see whether their accountants are from a single interface by ensuring that both funds are linked together, and reconciliations meet the balances of the trial balance.

### **Keywords**

Environmental performance, financial reporting quality, corporate social responsibility, manufacturing, Indonesia

## 1. Introduction

Indonesia's industrial sector remains an important industry contributing to the gross domestic product. The development of the non-oil and gas sector could contribute 4.77 trillion, or 19.86 percent of the overall Gross Domestic Product (GDP), according to data from the Ministry of Industry in 2018. This year, the volume of GDP accounted for by the manufacturing sector exceeded Rp2.95 thousand trillion, although it was reported this Rp14.84 trillion of GDP sits. Many businesses saw a high growth pace, including the automobile and manufacturing industries, which grew by 9.49%, the textile and footwear industries by 9.42%, the basic metals industry by 8.99%, the fashion and garment industries by 8.73% and the food and drink industries by 7.91% (OECD, 2018).

Indonesia's export industry production stood at USD39.7 billion in Trading Economics statistics for the third quarter of 2018. Indonesia's manufacturing sector production is the highest in the ASEAN area. Thailand led by Malaysia (USD 17.2 billion), Singapore (USD 16 billion), Vietnam (USD 8.2 billion), the Philippines (USD 8.2 billion), Cambodia (USD 2.8 billion), Laos (USD 1.1 billion) and Brunei Darussalam (USD 0.5 billion) in the second position. The Ministry of Industry reports that the non-oil and gas manufacturing sector was effective in the period 2015-2018 with an average growth of 4.87% and is now the sector that contributes the most to the national GDP, with deposits of up to 17.66% in 2018 Though the growth of 4.87 is also below the expected economic growth of 5% of the government (ASEAN, 2019).

The output of 19.86 percent from the industrial sector is a decent amount that needs to be remembered, but this figure contribution is shown to be contradictory with the nature of the industrial sector that can be managed with Indonesia. An industry's development is expected to affect the climate and industrial growth is no different. Indonesia is one of those countries with large-scale industrial growth. This makes Indonesia a so-called semi-industrial country. With that position, Indonesia should concentrate more on production efficiency. Whereas, until now, access to the produced waste remains out of the question. The problem of environmental contamination has recently become a hot topic in several different media (Yadav et al., 2016). It is attributed to the consequences of the waste produced as disease outbreaks that impact populations around the agriculture region. Waste output impacts both humans and the environment and must be dealt with for this waste. It is expected that business leaders do not just worry about the many advantages and set aside toxic waste management, as that would harm the manufacturing environment for many (Deswanto & Siregar, 2018). Companies in this industrial sector, particularly in the financial sector, are needed to sustain their effectiveness. Parties are looking for better outcomes and worry regarding the presence of the firm in the financial market. The owners believe the business to benefit from the funds already generated in equity purchases. Improving the financial efficiency is often demanded by the internal hands of the company. Usually this business outcome should be collected annually

from the financial report of the organization. Initial reports include information used to measure the extent of the financial performance of the company (Tjahjono & Eko, 2013). Besides being asked in terms of financial reports, the public and government also want firms in the industrial sector to be responsible for the impacts of the industries they manage. Manufacturing companies already running need to have an impact on the local environment. Proper management of toxic waste and the delivery of information to the public and enforcement with government environmental regulations are what industrial firms will do (Devie et al., 2019).

Environmental problems for governments, borrowers, and consumers are now constantly an issue. While, foreign consumers have issues with the sourcing and manufacturing methods of raw materials that prevent environmental concerns such as soil degradation, biodiversity loss and air pollution (Manurung & Rachmat, 2019; Purnomo & Widianingsih, 2012; Rahmawati, 2012). In recent years, however, there have been many industrial issues, such as ecological degradation triggered by the exploitation of energy without being compensated by improvements in the climate, the equilibrium of capital and the local ecology, such as pollution or plant contamination, which is very harmful to the Community. The question of well-being in the workforce is one issue that may lead to protests in such a manner that staff carry out marches and demonstrations, employees demand a policy implemented by businesses who do not comply with them, such as minimum wages and health facilities imposed by businesses who do not reflect justice (Manurung & Rachmat, 2019; Purnomo & Widianingsih, 2012).

The Indonesian Government is only starting to pay attention to projects for ecological conservation and environmental regeneration. Environmental Management and Preservation Legislation No. 32 of 2009 is a rule that the Government imposes to tackle the environmental impact of production. The operation in manufacturing is governed by Government Regulation No. 74 of the year 2001 on the handling of dangerous and harmful chemicals, Legislation No. 25 of 2007 on Investment, Legislation No. 40 of 2007 on Limited Liability Partnerships (UUPT) and Policy Regulation No. 47 of 2012; As for social and environmental responsibility, there is proof that the government is concerned about the biodiversity of the climate. Although environmental legislation has been enacted as well, these laws and regulations ought to be checked for usefulness in practice, so that they are not simply guidelines (Lingga & Suaryana, 2017). The program called Business Performance Rating Assessment System in Environmental Management was also created by the Ministry of Environment (KLH) as a form of environmental conservation help for enterprises. The practice is carried out in such a way that firms engaged in the industrial sector not only seek benefits but also have to pay heed to the environment around them (Kusumo & Kurnianto, 2019).

Corporate Social Responsibility (CSR) is seen as a form of corporate contribution to society and corporate allegiance to the community and its related parties (Handayani et al., 2017). This expands the responsibility of the corporation

into the conventional role by supplying the property's shareholders with financial statements. Gray et al., (2001); Sun et al., (2010) noted that CSR is the duty of the corporate world to hold all stakeholders accountable. The company will announce the operation of the organizational participation so that various partners know the sort of contributions the corporation has made. Disclosure of social responsibility or sometimes referred to as CSR reporting is the practice of disclosing social and environmental effects on the commercial practices of businesses in some areas within the society and as a whole (Gray et al., 2001; Lisdiyono, 2018; Murdifin et al., 2019; Wijaya et al., 2017). As a method of CSR monitoring, the annual report discloses social responsibility practices and relevant issues to convey the social obligation that has been introduced. In reporting social accountability in the annual statements of the firm, the company is supposed to be remembered for the moral status of the business and environmental concerns, so that the product will gain positive interest and the survival of the organization can be accomplished (Mardiya, 2018). In adopting the managerial concept that management should behave opportunistically, management can provide unnecessary specificity in annual reports by Corporate Social And Environmental Disclosure (CSED) to divert the attention of customers from financial statements to their income control (Wibowo et al., 2019). This has been confirmed by Prior et al., (2008) findings, which noticed that the monitoring of earnings has a direct impact on the declaration of CSR. CSR disclosure is a type of information on the application of social responsibility in the company's annual report. It is intended to illustrate the company's concern for the social obligation of customers, as that can be perceived as the reputation of the business as a moral commitment (Asrori et al., 2019; Gray et al., 2001).

Environmental issues impact the organization and are the duty of the business. The importance of this is that research is undertaken to determine the impact of disclosure in environmental management and corporate social responsibility on company outcomes. Henceforth, the purpose of the study is to examine the effect of CSR and environmental performance on the financial reporting quality of IDX-listed manufacturing firms.

The following paper has been followed as critical reviewing of the theoretical and empirical literature, discussion on the research methodology, results and findings of the study using PLS-SEM technique for data analysis and lastly, the critical discussions on the results in the light of previous studies, conclusive remarks and practical implications.

## **2. Literature Review**

Companies are found to have mainly focused on the environmental effects that occur due to the operation of the companies, due for this reason it is found to be described as environmental information for the benefits of the companies or improve its operations. Similarly, it had been found that about 25 such elements

exist which have different factors that can be examined to improve the operations of the companies (Smith et al., 2007). Moreover, there are contributing factors for environmental information that include energy, water along with biodiversity, emission and waste that waste is noted as B-3, products along with services of the company, transport, and compliance. According to Manurung & Rachmat (2019), companies should also focus on such platforms that are linked with the external factors which must be added in the financial statement of the companies which will be provided on annual basis. Companies that produce waste and address their operating needs and desires must include the information that is strictly relevant to the industrial management field. Also, the management of environmental performance must have the objective of fully complying with all the legislation and environmental requirements. Also, firms should reduce their activities that are linked with the management of the environment and avoid the environmental effects and keep it to scale set by the government (Tjahyono, 2009).

There were numerous studies could be found in the area where the environmental performance of the companies that could be linked with the financial reporting quality of the companies had different outcomes. The results of the following study concern the environmental performance to be measured by the PROPER and its effect on the financial reporting quality (Iriyanto & Nugroho, 2014). Furthermore, the author stated regarding the environmental performance of the Jakarta Stock Exchange that showed a significant effect on the ground of financial reporting quality (Almilia & Wijayanto, 2007). However, further research by Murdifin et al., (2019) that helps mining companies and HPH/HPHTI owners mentioned in the Indonesian Stock Exchange of Indonesia who sued to participate in the system named PROPER between 2008 and 2012 along with 13 companies. The authors addressed the findings where the environmental output has little impact on financial reporting. Also, the same author mentioned Indonesia's stock exchange companies that recorded from 2010 to 2011 (Tjahyono, 2009).

However, the outcomes have shown a significant impact on environmental performance on financial reporting quality. The investigation was carried out in which the mining firms listed to the Indonesian stock market forum between 2014 and 2016. The analysis at the time shows no effect on such variables (Vivianita & Nafasati, 2018). Furthermore, the outcomes also highlighted by Hasanah & Destalia (2017) where no impact was observed among environmental management activities merely due to the discovery and assessment and the closure of the reclamation on the financial reporting quality. The analyses were conducted between 2009 and 2011 in which the companies mentioned were all linked to the PROPER scheme in the Indonesian stock exchange (Haholongan, 2016). Further, Manurung & Rachmat (2019) research on manufacturing firms that were part of the PROPER 's system from 2011 to 2013 was also highlighted. In addition to this, the findings demonstrated that the environmental performance provides a large degree of impact that can illustrate the best information and provide a huge effect

on the consistency of financial reporting quality by the environmental performance.

Another study was carried out by Costello & Wittenberg-Moerman (2011) on company ground considered to be public on the Indonesian stock exchange from 2009 to 2013. The outcome shows that the environmental output has an impact on the firm's financial reporting quality. The research was completed, though, and the findings were discussed by (Rosyid, 2015), between 2010 to 2013, where the findings indicated positive effects of the variable. Whereas the research was carried out by another author arguing that environmental performance affects the financial reporting quality listed in the SOE companies on the Indonesia Stock Exchange platform between 2004 and 2011 stated by (Fitriani, 2013; Rizkan & Islahuddin, 2017). Moreover, the author named Yuliana (2019) The platform for manufacturing companies that also listened to about 34 companies in the same Indonesian stock exchange between 2012 and 2014 showed no effect of variables. The study was carried out again, which also showed no effect among the variables mentioned in the period 2008 to 2010 (Pratiwi & Setyoningsih, 2017).

The basis of corporate social responsibility is the platform where corporate social responsibility for their operations further transfers the annual report of the company and emphasizes the main point (Syed & Butt, 2017). The business needs to spend on the community and social grounds to build a positive picture of the organization's potential investors would then spend capital in the business for a positive picture of the brand and want to impact customer loyalty that buys goods and services (Asrori et al., 2019). Also, the company's sales are improving in the long term, so that the company's performance also improves. This increase in productivity demonstrates that the consistency of the financial reporting quality of the business will change over time (Syed & Butt, 2017).

The foundation of environmental performance is all about the efficiency of the organization which has a vision of environmental care. Nonetheless, environmental performance in the manufacturing context underlines the success of the business to build a healthy and successful atmosphere in companies (Centobelli et al., 2019). The government launched the program named Performance Appraisal Program which is also known as PROPER. Furthermore, this plan was strongly connected to other factors, such as having information regarding the success of the management of the business along with other stakeholders or as well as the field of investors focused on the growth of the market and the reputation of an organization in front of the public that will want to purchase the goods and services in the future by investing some amount of money in it. Such activities, therefore, increase the profitability of the companies and boost the sale of and help them main the financial reporting quality and play a vital role in improving it (Orazalin & Mahmood, 2018).

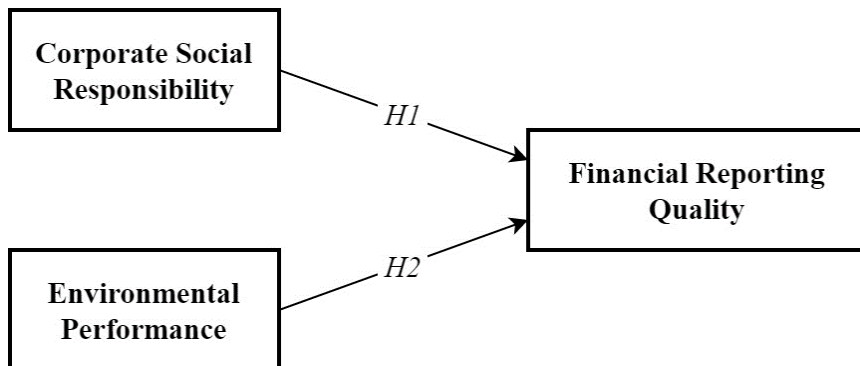
Nevertheless, the burden was placed on the part of the shareholders, where the corporations were active on the industrial side demonstrating social performance. CSR is recognized as the initiative that the organization will recognize

and not do in the interests of benefit by paying attention to the conditions generated by environmental concerns. The requirement was shown as the modern definition of the accounting network, moved from the conventional accounting principles increased stated by Purwati & Setyoningsih (2017). The organization needs the definition of practices that impact the society, where businesses are expected to carry out some type of action that reflects the information provided by the social and environmental grounds that influence because of the industrial operations (Deegan, 2002).

Several findings have been illustrated where the study indicates that the CSR dimension has influenced the states and companies have increased their corporate value (Purwati & Setyoningsih, 2017). However, the study has found out that CSR is the foundation for enhancing the standard of financial reporting by functioning social performance (Rosyid, 2015). Also, more work has been carried out on the impact of the financial reporting quality on the IDX manufacturing platform (Costello & Wittenberg-Moerman, 2011). Some work has been done on the problems created by the practices of the industrial sector have been created for environmental concerns, demonstrating the connection between the financial reporting quality and environmental performance as well as the practices of corporate social responsibility through which the following hypothesis has been created:

*H1: The greater the corporate social responsibility, the financial reporting quality of the company will be increased.*

*H2: The higher the environmental performance of the firm, the financial reporting quality of the company will be increased.*



**Figure 1:** Research Framework

### **3. Research Methods**

#### ***3.1. Research Design***

The positivism philosophy includes such data and information that had been gathered on natural and sensory basis and it can be investigated using scientific methods (Compte, 1854). In addition, quantitative approach has been identified as one of the data collection techniques that collects required data from target population (Bryman, 2017). This approach has been identified as a statistical one because it gathers numeric based data only. The quantitative approach helps in testing a theory and hypothesis development as well (Bahari, 2010). This approach is very highly systematic because of its ability to conduct the process in a quite effective and efficient manner. The use of quantitative approach helps the researcher in collecting large amount of data because of its efficient and easy process (Kothari, 2004). Therefore, positivism philosophy was used for data collection and quantitative approach had been implemented in this study. The reasons were that it helped in collecting positive and true information in a cost efficient manner. Moreover, explanatory purpose refers towards explaining the variables and objective of study in a more comprehensive and detailed way (Welman et al., 2005). This research purpose helps the researcher in understanding the in-depth phenomenon of research and provides enhanced information and knowledge. The explanatory purpose effectively helps in investigating those topics that were not studied before and provides more information and knowledge as well (Creswell, 2002). Hence, explanatory purpose was used in this study because it helped in explaining the idea and concept of research in a more extensive and proper way. In addition, correlational design is a non-experimental that examines the relationships between variables and identify their natural based occurrence (Kumar & Phrommathed, 2005). This design had been very helpful because of its ability to conduct the examination on natural grounds without any interference of external factor or activity. Also, it helps in providing the direction of their relation as well with their strength of relationship (Saunders et al., 2009). So, correlational design was used because it can examine the relations in natural environment.

#### ***3.2. Sampling Design***

The purposive sampling technique has been considered as a non-probability because it does not include the probability of every person to be selected in the sample size on equal basis. This technique helps in collecting rather close and relative data regarding the research objective and its variables (Sekaran & Bougie, 2010). The purposive sampling is very helpful because it is a judgmental one that identifies those people that are close to the research objective or target and collects highly in-depth data (Vehovar et al., 2016). Therefore, purposive sampling was applied in this study because it helped in gathering useful information that effectively helped in generating specific results.



### 3.3. Data Analysis

The PLS-SEM analysis includes two different kind of models named as measurement and structural model. The measurement model has a very important role because it provides the reliability and validity of data with high variance using Cronbach's alpha (Hair et al., 2011; Hair et al., 2012). On the other hand, structural model has the major role of hypothesis testing and it generated highly significant and effective results (Hair et al., 2014). So, PLS-SEM using SmartPLS 3.2.8 was used in this study because it can provide effective and better mediation results as compared to other techniques.

## 4. Results and Findings

### 4.1. Measurement Model

Following table 1 provides the result of the measurement model including indicator loadings, CR, and AVE coefficients.

**Table 1:** Measurement Model

Variables	Items	Loading	CR	AVE
Corporate Social Responsibility	CSR1	0.893	0.894	0.738
	CSR2	0.912		
	CSR3	0.764		
Environmental Performance	EP1	0.851	0.920	0.743
	EP2	0.906		
	EP3	0.899		
	EP5	0.785		
	EP4	0.785		
Financial Reporting Quality	FRQ4	0.799	0.823	0.700
	FRQ5	0.872		

In the above table, it has been shown that indicator reliability was found higher than the recommended threshold of 0.70 (Hair et al., 2011) ranging between 0.764 (CSR3) and 0.912 (CSR2) and therefore, construct validity using outer loadings has been achieved. Moreover, the coefficients of composite reliability (CR) were found higher than the recommended threshold of 0.80 (Hair et al., 2019) and the coefficients were ranged between 0.823 of financial report quality and 0.920 of environmental performance. Similarly, average variance extracted (AVE) was found higher than 0.50 as suggested by Hair et al., (2017) ranging from 0.700 for financial reporting quality to 0.743 for environmental performance. Henceforth, convergent validity based on AVE and CR was achieved by the recommended guidelines.

Table 2 provides the result of discriminant validity using the Fornell & Larcker (1981) criterion.

**Table 2:** Fornell & Larcker (1981) Criterion

	CSR	EP	FRQ
<b>Corporate Social Responsibility</b>	0.859		
<b>Environmental Performance</b>	0.094	0.862	
<b>Financial Reporting Quality</b>	0.445	0.529	0.837

In the above table, bold diagonal coefficients are the square-roots of AVE for each latent construct and these bold coefficients found higher than other constructs in the model. Hence, the study has achieved discriminant validity based on the recommended criterion of Fornell & Larcker (1981).

Following table 3 provides the result of discriminant validity using crossloadings.

**Table 3:** Crossloadings

	CSR	EP	FRQ
<b>CSR1</b>	0.893	0.014	0.397
<b>CSR2</b>	0.912	0.103	0.437
<b>CSR3</b>	0.764	0.140	0.296
<b>EP1</b>	-0.042	0.851	0.476
<b>EP2</b>	0.157	0.906	0.520
<b>EP3</b>	-0.015	0.899	0.451
<b>EP5</b>	0.258	0.785	0.353
<b>FRQ4</b>	0.237	0.471	0.799
<b>FRQ5</b>	0.485	0.422	0.872

In the above table, the bold values are the indicator reliability in their particular latent constructs while their cross loadings were also shown in the table. The bold values found higher in their respective constructs contrasting to their loadings in other latent constructs (Hair et al., 2016). Therefore, the study has achieved discriminant validity using cross loadings methodology.

Following table 4 provides the result of discriminant validity using the HTMT ratio.

**Table 4:** HTMT Ratio

	CSR	EP	FRQ
<b>Corporate Social Responsibility</b>			
<b>Environmental Performance</b>	0.223		
<b>Financial Reporting Quality</b>	0.617	0.740	

Above the table of HTMT ratio showed that all the HTMT ratio were below the recommended threshold of 0.85 (Henseler et al., 2016); justifying their discrimination with other constructs in the model and thereby, the study has manifested that all latent constructs have their presence and role in the analysis and none overlapping/correlation exists between latent construct (Henseler et al., 2015). Hence, discriminant validity using the HTMT ratio has been achieved.

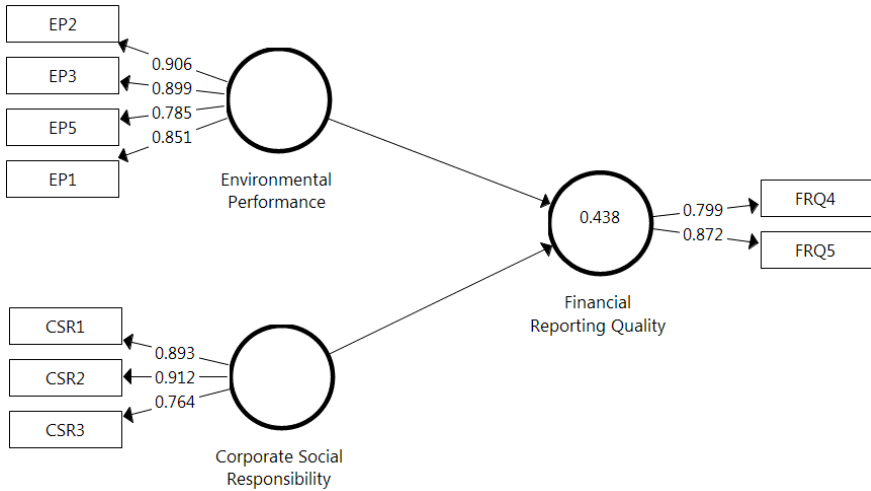


Figure 2: Illustration of the PLS Algorithm

The following table 5 provides the results of path analysis using PLS-SEM for hypothesis-testing based on PLS bootstrapping at 5000 subsamples and 5 percent statistical significance.

Table 5: Path Analysis

	Estimate	Prob.
Corporate Social Responsibility → Financial Reporting Quality	0.399	0.000
Environmental Performance → Financial Reporting Quality	0.492	0.000

The above table has shown that hypothesis-1 postulating that CSR ( $\beta = 0.399$ ,  $p < 0.001$ ) has a significantly positive effect on financial reporting quality has been accepted while hypothesis-2 positing that environmental performance ( $\beta = 0.492$ ,  $p < 0.001$ ) has a significantly positive effect on financial reporting quality has also been accepted.

Following table 6 provides the result of predictive relevance based on the recommended guidelines and methodology of Geisser (1975); Stone (1974) cross-validated redundancy estimations.

Table 6: Predictive Relevance

	R Square	Adj. R Square	Q Square
Financial Reporting Quality	0.438	0.434	0.281

The above table has shown that financial reporting quality has the predictability of 43.8 percent considered as moderate to high predictability (Hair et al., 2011); while the accuracy of 28.1 percent considered weak to moderate accuracy (Hair et al., 2013).

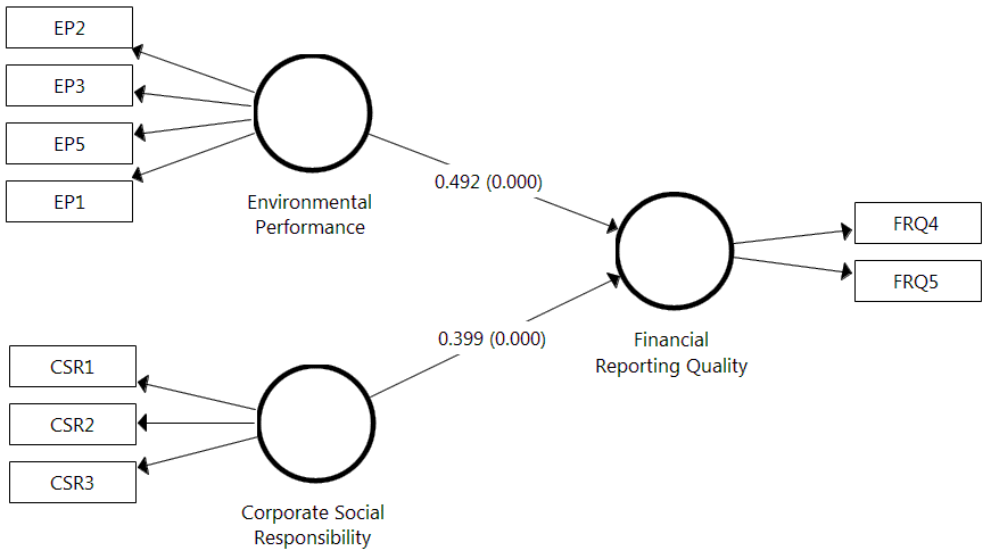


Figure 3: Illustration of PLS Bootstrapping

## 5. Conclusion

The specifics of the analysis were listed and clarified in the discussion portion, after which the conclusion must be examined by providing the answers to some queries described in this study. The environmental performance ground, however, has a positive and significant effect on the financial reporting quality of a company (Sundvik, 2019). There, the business is expected to rely extensively on the company's climate as it impacts the company's current operating operations or as well as in the potential in which the toxic waste program can do significant harm to the ecosystem (Bals, 2019; Pugh et al., 2019). Companies are expected to pay attention to the climate and environmental perspective that can have a strong response from all the society that cares about the business and cares about the future, thereby providing the organization a beneficial impact in the financial reporting quality (Bals, 2019). Organizations are expected to take account of the interest forum that is often concentrated on by the group to offer a good or negative answer depends on the judgment of the organization as it directly impacts the output of the business if the answer is successful then it would have a positive effect (Orazalin & Mahmood, 2018; Deswanto & Siregar, 2018).

The results of the study are having important consequences for decision leaders and stakeholders alike. The findings indicate that authorities can boost the consistency of financial statements by obliging companies to publish non-financial details (e.g., CSR-related details) while creditors may use the reported CSR information to predict the potential prospects of companies and assess the financial statements of companies with further assistance data. People are one of the main

factors which affect the quality of financial reporting (Alzeban, 2019; Bals, 2019; Pugh et al., 2019; Sundvik, 2019). Every management will be assured that their employees deliver high-quality results by objectively and ethically evaluating financials. Through openness will lead to better quality jobs, because transparent reporting lines promote more treatment for workers (Alzeban, 2019). All of the senior managers will recognize the things they are liable for recording, so they should be able to quickly locate the source of any knowledge to ensure their accuracy. Financial management covers all divisions of a company - while not all divisions produce income, they do have related costs. Enabling better coordination with all the teams would help render financial reporting more detailed. This would ensure more people would genuinely reach in when they have concerns regarding such numbers or products, rather than following an attitude of "that's their issue". You should stress the value of reliable financial statements by building a climate of teamwork and dramatically improve transparency within the employees. Closer management tools can help companies produce financial results quicker and more efficiently by optimizing the financial close phase. Implementing a technical system to assist manage the monthly closing cycle enables managers to see where their accountants are from a single interface by ensuring that both funds are linked together and reconciliations meet the balances of the trial balance. The financial close control program offers a common point of reality for the position of each team leader, eliminating miscommunications and opening up resources normally wasted on status changes.

Further, there are many drawbacks to our findings. Firstly, because of the huge institutional differences between Indonesia and developed markets, our results may not generalize to the developed markets. Future studies could use the compulsory legislation on CSR disclosure in other markets to support the results in this report. This research focuses mainly on the impact of CSR disclosure and excludes the impact of CSR results since we could not accurately assess the CSR output of a company.

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