CHAPTER 2

THEORETICAL BACKGROUND, PREVIOUS RESEARCH, AND HYPOTHESIS DEVELOPMENT

2.1 Signaling Theory

Signaling theory originally proposed by Spence (1973) to explain about job market behavior. Signaling theory helps to explain the behavior of two parties when they have access to different information. Strategic signaling refers to actions taken by a signaler to influence views and behaviors of receivers. Signaling theory has been widely used in accounting and auditing studies which proposed that management may signal something about the firm through various aspects of financial information disclosure, which can be viewed as a signal by investors. One of these aspects of disclosure is earnings timeliness. The timing of information disclosures may be seen as a signal of whether the firm has good news or bad news to tell. Early release of financial information may signal some underlying good news (such as earnings increases) that management wants the market to know as soon as possible. Delayed disclosure suggests bad news (such as earnings declines). This proposed relationship can be summed up as “good news early, bad news late”.

If there is unfavorable earnings news, however, management may fear a drop in share price resulting from prompt disclosure of this unfavorable news. The share price drop could increase the company's cost of capital and lead to a reduction of manager's compensation. These factors may encourage managers to delay the disclosure of their financial results. Thus career concerns can tempt managers to withhold bad news. These career concerns are arising from the effect of disclosure of bad news on the management compensation which leads managers to undergo the loss of less compensation payment resulting from a drop in the share price.

The timeliness of financial reporting is an important characteristic of usefulness of financial information. The timeliness of financial reports needs to be considered in order for them to be relevant. Research on timeliness emphasizes that annual reports need to be made available to decision makers before the financial information loses its capacity to influence economic decisions. It is not only necessary that users have financial information that is relevant to their predictions and decisions, but the information should also be current rather than relating only to prior periods. Timely reporting helps mitigate (or reduce the level of) insider trading, leaks and rumors in the market. (Owusu-Ansah, 2000).

2.2 Agency Theory

Agency theory suggests that shareholders require protection because management may not always act in the best interests of shareholders (Jensen and Meckling, 1976). Agency theory begins with the assumption that people act in their own self-interest, and that, under normal conditions, the goals, interests and risks of the two actors (principal and agent) are not identical. Agency theory states that when a manager does not own 100 per cent of company stock, there will inevitably be a latent conflict between shareholders and managers. This leads to numerous agency problems, such as excess spending as a result of special privileges, suboptimal investment decisions, information asymmetry and finance purchasing (Jensen and Meckling, 1976).

One of the remedies for the agency problem is to implement good corporate governance practices. The Organization for Economic Co-operation and Development (OECD) (2004) lists transparency as one element of good corporate governance. Reducing reporting lag is considered another component of good corporate governance practice to reduce agency problem (Blanchet, 2002). This illustrates that timeliness of reporting is not just as a creditable practice in itself but required as a critical mechanism to ensure transparency between the management and other stakeholders in a firm. This is also an essential element of adequate disclosure to ensure that there is no information asymmetry. The information used by investors and creditors should be current at the time of making the predictions and decisions.

2.3 Regulatory Framework of Timely Financial Reporting in Indonesia

In Act No. 8 year 1995 on Capital Markets, stated clearly that public companies are required to submit periodic reports and other incidental reports to Bapepam. More specific provisions about public company financial reporting are regulated by Bapepam in Regulation No. VIII.G.2, Bapepam Appendix No. KEP-38/PM 2003 concerning Annual Report which came into force on 17 January 1996. Then on December 7th 2006, to improve the quality of information disclosure to the public enacted Bapepam-LK No. XK6. Bapepam-LK Appendix No. KEP-134/BL/2006 concerning Obligation to Submit Annual Report for public Company.

In 1996, Bapepam issued Bapepam Decision No. KEP-80/PM/1996, which requires for each issuer and public companies to submit the company's annual financial statements and the independent auditor's report to Bapepam no later than the end of the fourth month (120 days) after the date of the annual financial statements. However, since September 30th 2003, Bapepam tighten regulation by the issuance of Bapepam Regulation No. X.K.2 Bapepam Decision No. KEP-36/PM/2003 concerning Obligation to submit Periodical Financial Statements.

Bapepam Regulation No. X.K.2 stated that the annual financial statements must be accompanied by auditor report with prevalent opinion, and submitted to Bapepam at least at the end of the third month (90 days) after the date of the annual financial statements. And in Bapepam-LK rule X.K.6 stated that in terms of overdue the time limit the submission of the annual report referred to the deadline for submission of annual financial statements as stipulated in Bapepam Regulation No. X.K.2 on Obligation to Submit Periodical Financial Reports, then it is considered as late submission of annual financial statements.

2.4 Timeliness

Timeliness of accounting information by SFAC No. 8 of the qualitative characteristics of accounting information, which is also stated in Hendriksen and Breda (1992: p.136) must be available to decision makers before it loses its capacity to influence decisions. The timeliness does not guarantee relevancy, but relevancy is not possible without punctuality. Timely information influenced managers' ability to respond to any incident or problem. If the information is not submitted on time it will lead to loss the value of information in influencing the quality of decisions.

Conceptually, timeliness denotes a quality of: (i) 'being available at a suitable time' or (ii) 'being well-timed' (Gregory and Van Horn, 1963: 576). The key variable in timeliness is the delay in release of' annual reports. Gregory and Van Horn (1963) defined delay as 'the length of time between the cut-off point (the time no transactions are accepted for inclusion in the particular report) and the distribution of reports to users.' Delay, in this study, is described as reporting lead time. Reporting lead time is defined here as the length of time a company takes after its financial year-end to release its financial information to the public.

There are two aspects of timeliness in financial reporting: (1) frequency of the reports; and (2) financial reporting lag. Frequency of reports issued by firms can be half-yearly, quarterly or monthly (Ku Ismail & Chandler, 2007). Financial reporting lag is the time lag, which is the period between the end of the financial reporting period and the date the financial reports are issued, or the date of the submission of the reports to the regulatory bodies.

The regulations of most capital markets in the world limit the time taken to disclose financial information to ensure that the users of financial reporting are capable to access financial data on time. For example, the regulations of Indonesia Capital Market Supervisory Agency (Bapepam) require companies to issue the annual statements within three months or 90 days quarterly financial reports within three months after the end of the financial period (Bapepam X.K.2). In the U.S. for example, the Securities Commission requires companies to disclose annual financial reports to the public within 90 days and quarterly financial reports within 45 days after the end of the financial period (Çelik, 2007).

Dyer and Mc Hugh (1975) used three criteria to look delays in their research: (1) Preliminary lag: the interval number of days between the dates of the financial statements to acceptance of the final report by the exchanges (2) The auditor's report lag: the interval number of days between the dates of the financial statements until the date of the auditor's report is signed,(3) The total lag: the interval number of days between the date of the financial statements until the date of receipt of a report published by the exchanges.

In accordance with rule X.K.2 issued by Bapepam, the submission of audited annual financial statements, it is timely if the financial statement submitted no later than the end of the third month (90 days) after the date of the annual financial statements.

Rule X.K.2 mentioned that the financial statements should be submitted to Bapepam consists of: (1) Statement of Financial Position, (2) Income Statement, (3) Statement of Changes in Equity, (4) Statement of Cash Flows, (5) other statements and explanatory material that are an integral part of the financial statements as required by the competent authority in accordance with the type of industry; (6) Notes to the financial statements.

2.5 Previous Research

Dyer and McHugh (1975) pioneered an empirical investigation into the timeliness of annual financial reporting of Australian companies. They examined the association between the reporting behavior of 120 companies listed on the Sydney Stock Exchange in June 1971 and company size, year-end closing date, and profitability. They studied preliminary, auditors' signature, and total reporting lags over a six year period to 1971. Dyer and McHugh (1975) found that company size and year-end closing date were significantly associated with total lag. They, however, reported no statistically significant relationship between timely reporting and profitability.

Courtis (1976) extended this line of research by examining the association between four additional corporate attributes and reporting delay of New Zealand listed companies. The attributes examined were company age, number of shareholders, number of pages of annual report, and industry. Except for industry, none of the attributes examined was significantly associated with auditors' signature lag. He found that whereas companies in the fuel and energy .and in the finance industries were fast reporters, those in the mining and exploration and in the service industries were slow reporters. Courtis (1976) observed that the companies in his sample took almost four and a half months beyond their financial year-end to report to shareholders. He attributed this lack of punctuality to the three months, on average, taken by New Zealand auditors to certify a client company's accounts.

(Owusu-Ansah, 2000) examined the timeliness of financial reporting of 47 companies in Zimbabwe, the test variable are firm size, profitability, gearing (speed), extraordinary items, months of the end of the financial year, the complexity of the company's operations and firm age. The results of empirical research found evidence that the size of the company, the complexity of the company's operations, company age and month of the financial year-end audit reporting affect the lead time. Then the size of the company, profitability, firm age and audit reporting lead time affects the speed of the company announced earnings initially, but only the size of the company that affect timeliness of year-end audited financial statements.

empirical investigation of the timeliness of annual reporting by 47 non-financial companies listed on the Zimbabwe Stock Exchange. It also reports on the factors that affect timely reporting by these companies. The results of a descriptive analysis indicate that 98% of the companies in the sample reported promptly to the public (i.e., submitted their audited annual reports to the Zimbabwe Stock Exchange by the regulatory deadline). A two-stage least squares regression identified company size, profitability and company age as statistically significant explanators of the differences in the timeliness of annual reports issued by the sample companies. No evidence was found to support the monitoring costs theory argument, which suggests that highlygeared companies are timely reporters. Furthermore, the empirical data indicate that audit reporting lead time is significantly associated with the timeliness with which sample companies release their preliminary annual earning announcement, but not with the timeliness of their audited annual reports.

In Indonesia, Hilmi & Ali (2008) conducted a study of factors that affect the timely submission of financial statements. Their results showed that the profitability, liquidity, public ownership and public accounting firm's reputation significantly affects the timeliness of financial statements, while the financial leverage, firm size and public accountants opinion does not significantly affect the timeliness of financial reporting.

2.6 Hypothesis Development

This section reviews empirical studies and developed the hypothesis related to seven factors of the timeliness of financial reporting: 1) profitability; 2) leverage; 3) liquidity; 4) company size; 5) audit opinion.

2.6.1 Profitability and Timeliness of Financial Reporting

Profitability is one indicator of the company to make a profit, the higher the profitability, the higher the company's ability to generate profits. Companies reporting a loss for the period were expected to have a longer reporting. The expected role of a reporting loss is suggested for several reasons. First, where a loss occurs, companies may wish to delay the bad news. A company with a loss may request the auditor to schedule the start of the audit later than usual. Second, an auditor may proceed more cautiously during the audit process in response to a company loss if the auditor believes the company's loss increases the likelihood of financial failure or management fraud.

Prior empirical findings suggest that firms with bad news, or that experienced losses, tend to delay reports longer than firms with good news (Owusu-Ansah, 2000). Profitability is expected to influence the timeliness of firm financial reporting. A firm‘s performance has a signaling effect on the market for corporate securities (Watts and Zimmerman, 1990). A rise in the market due to good news (positive performance) will raise the market value of outstanding equity shares and management and the opposite is true of a firm with bad news (negative performance). Therefore, it is reasonable to expect the management of a successful firm to report good news to the public on a timely basis (Mahajan and

Chander, 2008). As determined by (Al-Ajmi, 2008), good and bad news are factors that determine both audit report time lags and financial reporting time lags. In addition, early publication signals positive news about firm performance.

Major prior studies have found that a firm‘s financial performance is positively associated with audit report time lag which impacts on the timeliness of the release of annual reports. Thus, the following hypothesis is developed:

H1: Profitability is positively associated with the timeliness of financial reporting companies in Indonesia.

2.6.2 Leverage and Timeliness of Financial Reporting

Leverage is a ratio to measure how a company depends on the creditor to finance their assets. The higher debt-to-equity ratio reflects a high level of financial risk. The company's high financial risk indicates that the company is experiencing financial difficulties (financial distress) due to high liabilities. A financial difficulty of company is considered as a bad news that will affect the company image in the public.

Prior empirical findings said that companies with high leverage means they rely heavily on external borrowing to finance its assets, while the company has low leverage, finance its assets with its own capital. Thus, the higher leverage means higher risk because there is a possibility the company unable to settle its obligations in the form of principal and interest (Soekadi, 1990).

Al-Ajmi (2008) finds that highly leveraged firms tend to delay publication of their annual reports, as well as have longer audit report time lags. Moreover, another view contends that highly leveraged firms report more slowly than less leveraged firms. Supporters of this view believe that a high ratio of debt to equity increases the probability of failure (Owusu-Ansah, 2000), particularly when the general economy is poor. A high ratio of debt to total assets means a high risk of bankruptcy or management fraud, resulting in an increase in the time auditors need to complete their substantive tests of transactions and delaying reporting. The following hypothesis is developed:

H2: Leverage is negatively associated with the timeliness of financial reporting companies in Indonesia.

2.6.3 Liquidity and Timeliness of Financial Reporting

Liquidity refers to the ability of the company to meet its short-term liabilities maturing in a timely manner. Companies that have sufficient ability to repay short-term debt known as the company that liquid. High liquidity levels at a company show that the company can meet its short-term obligations well, while a low level of liquidity indicate that the company unable to meet its short-term obligations properly. Companies that have demonstrated high levels of liquidity show good news; it will affect the company to submit its financial statements in a timely manner because it will make the market reaction positive for the company.

Research by Hilmi & Ali (2008) provides empirical evidence that liquidity affects the timeliness of the company's financial statements. If the ratio of current assets to current liabilities is greater, this means that the higher the company's ability to cover short-term liabilities. Companies that have a high level of liquidity indicate that the company has a high ability to repay short-term liabilities. This is considered as good news hence companies with this condition tend to be timely in the delivery of financial statements. The following hypothesis is developed:

H3: Liquidity is positively associated with the timeliness of financial reporting companies in Indonesia.

2.6.4 Company Size and Timeliness of Financial Reporting

Firm size has often been recognized as one of the important corporate attributes associated with financial reporting timeliness. It has been a major variable of interest in most timeliness reporting studies examining its association with financial information reporting delays. Usually, large companies are timely reporters for several reasons.

First, they have more resources, more accounting staff and sophisticated accounting information systems that result in more timely annual reports. Furthermore, large companies are able to install and operate modem computer-assisted devices that are fast in processing and monitoring inventories and production operations. The use of these devices results in a faster preparation of accounts and more timely annual reporting.

Second, large companies tend to have strong internal control systems with the consequence that auditors spend less time in conducting compliance and substantive tests. Audit delays are, therefore, minimized and this enables the companies to report promptly to the public.

Third, large companies tend to be followed by a relatively large number of financial analysts who usually rely on timely release of annual reports to confirm and revise their expectations of companies' present and future economic prospects. Anecdotal evidence suggests that financial analysts interpret undue delay in reporting as an attempt to conceal information that may adversely affect the value of a company. Since large companies are generally followed by a relatively large number of analysts, there is an incentive for such companies to report timely to avoid speculative trading in their shares.

Finally, the available empirical evidence suggests that large companies report on a more timely basis than their smaller counterparts (e.g. Dyer and McHugh, 1975; Ashton et al., 1989). It is, therefore, the following hypothesis is developed:

H4: Company size is positively associated with the timeliness of financial reporting companies in Indonesia.

2.6.5 Audit Opinion and Timeliness of Financial Reporting

The main purpose of an audited financial statements is to express an opinion whether the client's financial statements presented fairly, in all material respects, in accordance with generally acceptable accounting principles in Indonesia (Mulyadi, 2002, p.73).

The rationale of audit opinion is similar to the profitability variable. That is, companies receiving a qualification may view this as bad news and slow down the audit process. For example, a company might not respond in a timely fashion to requests from the auditor. The receipt of a non-standard audit report might be symptomatic of auditor company conflict which would also tend to increase audit delay.

The audit report is a formal tool that is used to communicate the auditor's conclusions about the audited financial statements to the parties concerned. The auditor is one party that plays an important role for the achievement of quality financial reporting in capital markets. Auditor's duty is giving assurance to the fairness of the financial statements submitted by the company. The assurance of financial statements is given by the auditor's opinion (Hilmi and Ali, 2008).

Whittred (1980) finds that qualified reports delay the release of annual reports and that this delay increases with the seriousness of the qualification. Ashton *et al.* (1987) investigate 14 corporate attributes and finds that audit delay is significantly longer for firms that receive qualified audit opinions. Firms always view audit qualified opinions as ‘bad news‘ and may not promptly respond to auditor requests.

Carslaw and Kaplan (1991) also stated that the late submission of financial statements is positively associated with audit opinion given by auditors and companies that do not receive an unqualified audit opinion have a longer delay. Means the company which received an unqualified opinion from the auditors for the financial statements tend to be more timely in submitting their financial statements as unqualified opinion is good news from auditor. Instead, the company will likely late to submit its financial statements when receiving other than unqualified opinion because it is assumed as bad news.

According to the PSA 29 Section 508 in SA Generally Accepted Accounting Standards, there are five types of auditor's opinion, namely: 1) Unqualified opinion; 2) Unqualified opinion with explanatory language; 3) Qualified opinion; 4) Adverse opinion; and 5) Disclaimer opinion.

In this study, unqualified opinions include unqualified opinion and unqualified opinion with explanatory language, while qualified opinions include qualified opinion, adverse opinion, and disclaimer opinion. Thus, the following hypothesis is developed:

H5: Unqualified audit opinion is positively associated with timeliness financial reporting companies in Indonesia.