The Influence of Financial Reporting Quality: Accounting and Market-Based

by Elvira Luthan

The Influence of Financial Reporting Quality: Accounting and Market-Based to *Information Asymmetry* (Studied in Manufacturing Companies Listed in Indonesia Stock Exchange)

By
Elvira Luthan
Fak Ekonomi, Univ Andalas
viraluthan@gmail.com
Suci Wahyuliza
Fak Ekonomi, Univ Bung Hatta
suci_wahyuliza@yahoo.com

ABSTRACT

This research aims to test the influence of the quality of financial reporting based on accounting and market to the asymmetry of information. The samples that were used the manufacturing companies listed on the Indonesia stock exchange from 2007 until 2011. The sampling technique was using purposive sampling and obtained a sample of 41 companies.

Hypothesis test results showed that the quality of accounting based financial reporting is represented by three indicators, namely persistence, income smoothing and predictability. Persistence and predictability did not affect the asymmetry of information whereas the income smoothing affects it. Further, market based financial reporting quality is represented by three indicators, namely the value relevance of profit, timeliness and conservatism. The value relevance and timeliness did not effect on information asymmetry while the conservatism has. It can be concluded that information asymmetry can be influenced by the quality of financial reporting depend on indicators that were used.

Keyword: *Asymmetry of Information, quality of financial reporting, market and accounting based.*

I. Introduction

1.1 Background

The intense competition in the business that should be considered for the management to show a good performance within the corporate which they managed. Because of the performance will give the effect to the interest of investors to invest in the company. Besides, the company management is also responsible for providing accurate financial reports to all interested parts. Financial reporting is the primary medium of delivering information to both inside (internal) or outside (external) companies (Belkaoui, 2006). Internal part such as directors and managers require financial reporting to make decisions of regarding the company's strategy. While the external parts such as shareholders use financial reporting as a basis for consideration in making investment decisions, (Santoso, 2012). The information that available in financial reporting is the result of an accounting activities consisting of identifying, measuring relevant data, process and gives an overview of the performance of the company to investors and other parts. In order to make the information beneficial, the financial statements must be qualified.

Francis *et al.* (2004) said that the quality of financial reporting can view through two major groups, namely financial reporting quality of characteristics based accounting *(accounting-based attributes)* and market-based attributes *(market-based attributes).* Besides, Fananai (2009) stated, the quality of financial reporting is closely related to the performance of the company as seen from the company's profit. The information of financial reporting that has good quality if the profit for the year used as an indicator for corporate profits in the future. It shows that the focus of the company's financial reporting quality measurement is related to the properties of financial reporting. Therefore, as a manager, the manager is obliged to give a signal about the state of the company to the owner. Give signal can be done through the disclosure of accounting information such as financial statements.

There are various studies that have been conducted by several researchers who conclude that if the quality of financial reporting increases, the gap of information obtained by those who need to decrease {Copeland and Galai (1983), Cohen (2003), Fanani (2009); Indriani (2010); Apriliani (2012)}. In other words, the quality of information generated through the company's financial statements can minimize the information gap that could harm investors.

This study reviewed some previous studies by changing the variables and indicators of the study period. The quality of financial statements used in this study viewed from two different viewpoints, namely the quality of financial reporting-based and market-based accounting. The quality of financial statements measured with persistence, predictability and smoothing earnings as an indicator for the quality of financial reporting based on the value relevance of accounting whereas, timeliness and conservatism as an indicator for the quality of market-based financial reporting.

1.2 Formulation of the Problem

Based on the description above, the formulation of the problem in this study are:

a. How does the effect of financial reporting accounting-based quality which based on the persistence, predictability, and smoothing income through information gap?
b. How does the effect of financial reporting accounting-based quality which based on the relevance value, timeliness, and conservatism through information gap?

II. Overview Literature

Jensen and Meckling (1976) states that the separation between managers and owners are very vulnerable through the problem that called an agency problem *(agency problems)*. Agency theory focuses on two individuals, namely principal and agent. Principals delegate responsibility to agents. Neither the principal nor the agent is assumed to be the rational economic motivated solely by self-interest, but they have difficulty distinguishing awards for preferences, beliefs and information. The rights and obligations of the principal and the agent are described in an agreement that is mutually beneficial working. (Raharjo, 2007). As a management company that runs the company which has more information about the company they manage, compared with the company owner. This situation can also be explained by the theory of signal.

According to Wolk, *et al* (2001), signaling theory is explaining how important the company provides information to external parts. Signaling theory is also related to the information gap between the management company and the stakeholders. Signaling theory suggests about how a company should give a signal to the users of financial statements, Jama'an (2008). One of the types of information released by the company that can be a signal for parts outside the company is the annual report. The information disclosed in the annual report may include accounting information is information relating to the financial statements and non-accounting information is information that is not related to the financial statements.

2.1. Asymmetries information

Information gap is a condition in which the management has more information than the investor. Jensen and Meckling (1976) explain that the greater the gap will increase the chance of information managers to manipulate financial statements. Manipulating financial statements also creates agency costs created by the manager with the goal to move the shareholder wealth gains from the sale of company's shares. Managers will manipulate the information they provide to investors in order to increase the stock price. The increase in the stock price gives benefit to the manager because the greater the revenue from the sale of shares that they get. These circumstances provide benefits to managers and cause losses to investors, because the investors have to spend some money to buy stocks, but they do not make a profit. Besides, assessment and management of performance bonuses is also a contributing factor manipulation of financial statements (Haniati, et al., 2010).

There are two types of information gaps: *adverse selection* and *moral hazard, (*Jensen and Meckling, 1976):

a. Adverse selection is the type of information asymmetry in which one or more parties hold / will hold a business transaction, or potential business transaction has more information on other parties. Adverse selection occurs because some people like corporate managers and other stakeholders in the company are now more aware of the condition and future prospects of a company rather than the outsiders.
b. Moral hazard is the type of information asymmetry in which one or more parties who hold or will hold a business transaction or a potential business transaction can observe their actions in the settlement of their transactions while the other parties do not. It may occur due to the separation of ownership and control that is characteristic of most large corporations.

Financial information is helpful if it has the qualities to be able to influence the decisions of investors. The quality of information can be increased if the asymmetric information is low. Investors can observe any management policy and internal company information. The ideal condition is difficult to create, but pursued through regulation to protect investors who are in a situation of lack of information (Scott, 2000).

In this study, researchers measured the gap of information by using a proxy bid-ask spreads. The term, ask associated with selling limit order, while the bid associated with buying limit orders. Bid-ask spreads is defined by the difference between the highest buying price from investors by selling price proposed by the issuer or seller of the stock. Literature on bid-ask spreads stating that there is a component of the spread that contribute to the losses experienced dealers when trading with informed traders are as follows (Rahmawati, et al, 2006).

1. *Order-processing costs,* include the cost of buying or selling shares, which covers the cost of administration, reporting, process computers, etc., as well as compensation for time spent by a securities dealer to complete the transaction.
2. *Inventory holding costs,* or ownership costs that are incurred by the traders during the securities having shares that can be traded in accordance with the request.
3. *Adverse selection component* or the cost of information asymmetry arises due to differences in ownership and access to information in the market. One party has enough information, while others have less information. The seller stock investors have to understand that the information will only trade if deemed beneficial for them. On the other hand, the seller also understands that the stock would benefit if they deal with investors who have less information.

2.2 Financial Reporting Quality

Financial reporting in accordance with SFAC (Statement of Financial Accounting Concept) No. 1, Objectives of Financial Reporting by Business Enterprises consists of:

c. Basic financial statements which consists of the financial statements and notes of the financial statements.
d. *Supplementary Information*
e. *Other Means of Financial Reporting*

Belkaoui (2006) said that the main focus of financial reporting is information about earnings and its components. Generally, earnings iinformation based on accrual accounting will give a better indication of the current ability and going concers of the company to produce the desired cash flow, compared with only limited information on the financial impact of cash flow.

Financial reporting is not the only source of information that used for making business decisions. To meet the needs of the user, the information presented in the financial statements must have certain characteristics. *"Trueblood Report"* mentions seven qualitative characteristics of reporting, namely: a) the relevance and materialistic, b) the form and substance, c) reliability, d) freedom of bias, e) comparability, f) consistency, g) can be understood. According to the report, the qualitative characteristics of financial statements should be largely based on the needs of the users of the report. Information should be as far as possible free from bias maker. It said to be of high-quality financial reporting if the profit for the year can be a good indicator to predict the company's future earnings or strongly associated with operating cash flow in the future (Fanani, 2008).

Francis, *et al.* (2004) and Schipper (2004) classify the quality of financial reporting in two parts namely the indicator-based and market-based accounting. The quality of accounting-based financial reporting quality emphasizes on the quality of financial reporting that is useful to the reader as shareholders or investors who want to invest in the company, how a financial statement that models the performance and prospects of the company must be prepared in accordance with the actual state of the company and in accordance with accounting-based generally accepted. While the quality of financial reports emphasize market-based financial reporting quality is judged by the market response. Market-based financial statements illustrate the tradeoffs between financial statements published by companies with stock market performance reflected in variations in *returns* and share price related asymmetries information (Santoso, 2012).

2.5 Theoretical Framework and Hypothesis Development

The ability of the financial reporting affect the information asymmetry is a strategy that must be observed so that the information asymmetry can be reduced. Because of it is an important element in achieving corporate excellence. Based on the description above, the image frame of mind and the hypothesis can be presented as follows:

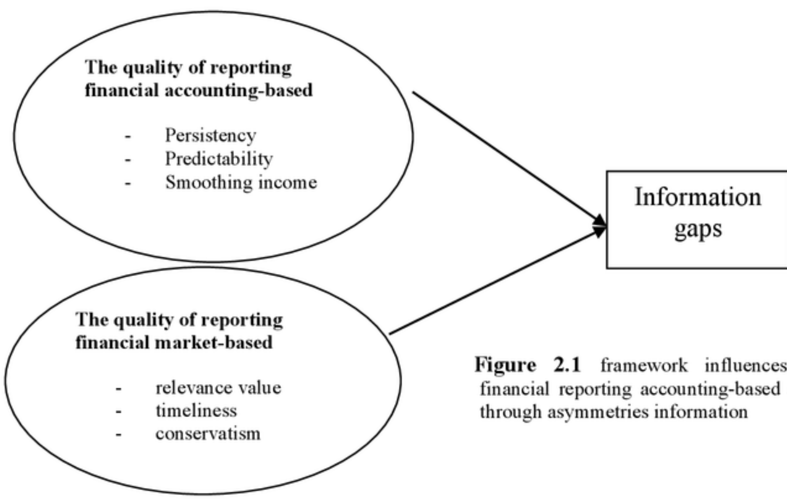

Figure 2.1 framework influences the quality of financial reporting accounting-based and market-based through asymmetries information

The research hypothesis

H $_{1a:}$ The quality of financial reporting accounting-based proxies to influence the persistence of asymmetries information

H $_{1b:}$ The quality of financial reporting accounting-based which proxy on predictability affects the information gap

H $_{1c:}$ The quality of financial reporting accounting-based which proxy on accounting-based of smoothing income effect on asymmetries information

H_{2a}: The quality of financial reporting market-based which proxy market affects the value relevance of asymmetries information
H_{2b}: The quality of financial reporting market-based which proxy on timeliness affects the appropriateness of the information gap
H_{2c}: The quality of financial reporting market-based which proxy on conservatism influence the information gap

III. Research Methodology
3.1 Population and Sample

The population of the study is all manufacturing companies listed on the Indonesia Stock Exchange (IDX). The sample selection is done by using *purposive sampling* method. The criteria for the samples in this study are as follows:

1. Company published financial statement with the annual reporting period ending on December 31.
2. Companies listed respectively report the profit from 2007 to 2011
3. Companies that do not get loss and the companies who had complete data

3.2 Data and Sources of the Data

In this study, the data that will use is secondary data. Sources of data used in this study derived from the stock price data, demand price, the bid price, and trading volume in the *Indonesian Capital Market Directory* (ICMD) obtained from the IDX Capital Market Reference Center. Data collected with documentation techniques, i.e., by collecting data about the company's financial statements, especially the sample research through a medium (intermediate) or the official websites of the company.

3.3 Operational and Definition of Variables
3.3.1 Dependent Variable: Asymmetries information

Economic consequences of financial reporting quality of information generated for investors can be asymmetries information. Measurement of the information gap used in this study is *the bid-ask spread.* This study uses the model used by previous studies, Fanani (2009) as follows:

$$\mathbf{SPREAD}_{it} = (\mathbf{ask}_{it} - \mathbf{bid}_{it)}) / [(\mathbf{ask} + \mathbf{bid}_{it\,it)}) / 2] \times 100$$

Specification:

$SPREAD_{it}$: relative *bid-ask* spread of firm i on day t
Ask_{it} : *ask* price (bid), the highest share of firm i on day t
Bid_{it} : the price *bid* (ask) the lowest stock of firm i on day t

3.3.2 Independent Variables

1. **Financial Reporting Accounting-Based Quality**

Table 3.2
Operational definition and measurement of variables

Variables	Definition	Formulas
1.Persistency (Francis *et al*, 2004)	Condition that the profit for the period now is a reflection of future periods or current period	$= B\,0 + \beta 1 +$ εjt Where: Comprehensive income company Earningsjt = j year-t Eanisgsjt-1 = firm j Comprehensive income last year Osjt = Number of shares outstanding of firm j in year t Osjt = Number of shares outstanding of firm j in year t β = Persistence
2. **Predictability (Francis *et al*,**	Ability profit now in predicting future	$= B\,0 + \beta 1 +$ εjt Where:

2004)	earnings upcoming	Earnings sjt = Income (loss) Comprehensive enterprise-j year t Eanisgsjt-1 = Income (loss) Comprehensive company j years ago Osjt = Number of shares outstanding of firm j in year t β = predictability
3.Smoothing the profit (Francis *et al*, 004)	differences between firms variability in terms of profit according to the actual cash flow	**Income smoothing =** Where: NIBEjt = profit (loss) Comprehensive company j in year t CFOjt = operating cash flow of firm j in year t

Source: Data is own processed

2. Financial Reporting Market-Based Quality

Table 3.3
Operational definition and measurement of variables

Variables	Definition	Formulas
1.Relevant Value (Francis *et al*, 2004)	The ability of earnings to explain variation in the reward, where greater explanatory power is seen as a desirable	***Value Relevance* = - jt** *Adjusted R* ² obtained from the following equation: **RETjt = β0 + β1 + β2 Δ *Earnings Earnings* jt jt + εjt** Specification: RETjt = Return on average for 15 months (in January of year t until March of year t + 1) of firm j in year t *Earningsjt* = Net profit comprehensive company j in year t
2.Timeliness (Francis *et al*, 2004)	The ability of earnings to explain variation in the reward, where greater explanatory power is seen as a desirable	***Timeliness* = - jt** *Adjusted R* ² obtained from the following equation: ***Earnings* jt = β0 + β1 + β2 NEGjt NEGjt RETjt + β3 * RETjt + εjt** Specification: RETjt = Return on average for 15 months (in January of year t until March of year t + 1) of firm j in year t Net income *Earnings* jt = comprehensively firm j in year t NEGjt = Dummy variable, 1 if RETjt <0 and 0 for the others.
3.Conservatism (Givoly and HYN, 2002)	The ability to verify differences necessary in order to prove whether the obtained is profit or loss	$C_{it} = NI_{it} - CF_{it}$ Specification: C_{it} = Level of Conservatism firm i at period t NI_{it} = earnings before deducting depression extra0rdinary items and amortization of firm i in period t CF_{it} = Cash Flow from operating activities of firm i at t period

Source: Data is own processed

3. Hypothesis Testing

3.5.1 Multiple Regression Analysis

A multiple linear regression model is as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_{6+} + e$$

Where:

α = constant
Y = Information asymmetry
$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6,$ = Coefficient Regression Each Variable
X_1 = persistence
X_2 = predictability
X_3 = smoothing earnings
X_4 = Relevance value
X_5 = Timeliness
X_6 = conservatism and e = Term *Error*

IV. DISCUSSION

4.1 Description of the Data

The population of the study was manufacturing company listed in Indonesia Stock Exchange (http://www.idx.co.id), for the samples selection was used *purposive sampling method.* The samples is 144 firm listed. Accordance to criteria sample, of 144 listed companies, 43 companies that do not meet the second criterion, the 21 companies that did not meet the three criteria, and 32 companies that do not meet the criteria of four and seven companies are experiencing outliers. So, only 41 companies that meet the criteria as the study sample.

4.2 Descriptive Statistics

Descriptive statistics of test results can be shown in Table 4.1. The independent variable is the quality of financial reporting that is market-based persistence (x_1), predictability (x_2), smoothing income (x3) and market-based financial reporting is the relevance value (x4), appropriateness (x5), conservatism (x_6). While the dependent variable, Y is an information gap.

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Y	41	.00	.01	.0016	.00112
X1	41	-4.03	2.02	.3448	.93003
X2	41	-1.52	2.02	.6130	.73217
X3	41	.08	2.21	.6666	.49294
X4	41	-.93	.97	.1454	.52088
X5	41	-2.65	1.00	.0045	.66030
X6	41	-18.12	10.68	-11.2208	7.30903
Valid N (listwise)	41				

4.3 Classical Assumption Test Result

Classical assumption test results can be shown in Table 4.2, It can be said that the data from the sample and the variables used to escape the classical assumption test.

Table 4.2.
Recapitulation of Classical Assumption Test Results

Hypothesis	Normality Test	Multicollinearity Test	Test Hesterokedasitas	Autocorrelation Test
H1	Residual normally distributed data	Tolerance: 0.768 and VIF: 1,303	Not going Heterokedasitas	DW: 1,744
H2	Residual Data normally distributed with	Tolerance: 0.787 and VIF: 1,271	Not occur Heterokedasitas	DW: 1,744
H3	Residual normally distributed data	Tolerance: 0.781 and VIF: 1,281	Not going Heterokedasitas	DW: 1,744
H4	Residual normally distributed data	Tolerance: 0.894 and VIF: 1,118	Not going Heterokedasitas	DW: 1,744
H5	Residual normally distributed data	Tolerance: 0.851 and VIF: 1,175	Not going Heterokedasitas	DW: 1,744
H6	Residual normally distributed data	Tolerance: 0.688 and VIF: 1,454	Not going Heterokedasitas	DW: 1,744

Source: Data processed its own

4. **Hypothesis Testing Results**

Hypothesis testing was conducted using multiple linear regression; the results can be shown in Table 4.3.

Table 4.3
Test Results of Multiple Linear Regressions

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig
	B	Std. Error	Beta		
1 (Constant)	.003	.001		5906	.000
Persistence (X_{1})	.000	.000	.044	.264	.793
Predictability (X_{2})	.000	.000	-.289	-1760	.087
Gain Flattening (X_{3})	-.001	.001	-.380	-2305	.027
Relevance Value (X_{4})	.000	.000	.081	.524	.604
Appropriateness (X_{5})	.000	.000	-.289	-1832	.076
Conservatism (X_{6})	.000	.000	.402	2,291	.028

Source: Data processed its own

4.5 Discussion of the Results from Hypothesis Testing asymmetries information

1. **The Effect of Persistence through Asymmetries information**

Hypothesis H_{1a} rejected because of the significant value that is greater than the value of the constant is 0.793> 0.05 level. The lack of persistence effect of the information gap indicating that persistence cannot reduce the information gap that occurs between corporate managers and shareholders or other stakeholders. It caused by the information generated from corporate earnings persistence cannot be captured or understood by users of financial statements (investors, etc.), so persistence is less able to reduce the information gap between managers and other parts.

This research is not consistent with the study conducted by Copeland and Galai (1983), Fanani (2009), Cohen (2003), and Apriliani (2012); they stated that if the quality of financial reporting increases will be able to reduce the information gap. So that the information obtained between the managers and other shareholders draw and there are no losers.

2. **The influence of the Information Gap Predictability**

Hypothesis H_{1b} is rejected, because the significant value is greater than the value of the constant is 0.087> 0.05 level. It means that predictability indicators representing the quality of the accounting-based financial reporting is less able to reduce the information gap that occurs between the company management and external parts such as investors and other parts. This is due to the lack of information contained in the financial statements and the lack of explanation for such information. The high quality of financial reporting does not guarantee that the information can reduce the gap between management and external parts. The role of financial reporting quality as represented by predictability which seen as a thing that can protect by the shareholders from asymetri information. In accordance with agency theory, the owner of the company will bridge the conflict between shareholders and managers of the company. One of them is the owner of the company wants managers to be able to improve the welfare of the shareholders.

Predictability must improve the quality of financial reporting and may reduce the information gap. However, the results of this study indicate that predictability not affect the information gap. The results of this study are inconsistent with previous research conducted by Copeland and Galai (1983), Fanani (2009), Cohen (2003), and Apriliani (2012), which reveals the quality of financial reporting negatively effect of information gap, the increasing quality of financial reporting the information gap decreases.

3. The Effect of Smoothing Income through Inequality information

Hypothesis H $_{1c}$ accepted, because the value obtained significantly smaller than the value of the constant is 0.027> 0.05. It means that income smoothing indicator that represents the quality of the accounting-based financial reporting to reduce the information gap that occurs between the company management and external parts such as investors and other parts.

It is in line with previous studies, the higher the quality of financial reporting, the lower the information gap that will result, in other words the high quality of a company's financial reporting will give a negative influence on the information gap. Because of the accuracy of the information element of a financial statement that reports the resulting information in the financial statements cannot be manipulated again by the parts who want to take advantage from a financial reporting.

4. The Effect of Relevance Value on Asymmetries information

Hypothesis H_{2a} is rejected, because the significant value that is greater than the value of the constant is 0604> 0:05. It means that there is less relevant information can provide insight to investors, creditors and other parts that managers have provided quality information, so some investors, creditors and other parts did not react positively to it. Then there was a gap of information between internal and external parts. Though the relevance of value is supposed to improve the quality of financial reporting which can reduce the information gap.

The results of this study in line with Indriani, et al (2012) and Santoso (2012) stated the quality of financial reporting does not affect the information gap, in other words, the higher the quality of financial reporting, the higher the information gap that can be caused. It is also in line with research conducted by Apriliani (2012), the market-based financial reporting quality has no influence on the obtained information gap, and it shows that the relevance value is less able to reduce the information gap.

5. The Effect of Appropriateness through Asymmetries information

Hypothesis His rejected, because the significant value that is greater than the value of the constant is 0.076> 0.05 level. It means that there is less timely information can provide insight to investors and other parts that the manager has provided quality information, so that external parts do not react well to such information. Therefore, it often occurs that information gap can resulting external parts harmed.

The results of this study are consistent with Apriliani (2012), which is the market-based financial reporting quality has gained significant influence on asymmetries information. Absence of the influence showed that some indicators of market-based financial reporting quality as less directly appropriateness can reduce the information gap. These results are also consistent with research conducted by Indriani and Khoiriyah (2010). This proves that despite the high quality of financial reporting, not necessarily the information contained therein is captured perfectly by the user. The lack of information obtained from financial statements that lead to asymmetry of information. The difference in the results obtained in this study with the previous due to the influence between earnings and *returns,* in Indonesia, the effect of income on the *returns* have very little effect (Indriani and Khoriyah 2010).

6. The Effect of Conservatism through Asymetri Information

Hypothesis H $_{2c}$ accepted, because the value obtained significantly smaller than the value of the constant is 0.028> 0.05. It means that the quality of financial reporting with the market-based indicators of conservatism may provide a negative influence on the asymmetries information or to reduce the information gap between internal and external parts.

These results are in line with research conducted by previous studies that Haniati and Fitriany (2010) research results proved that conservatism significantly and negatively related to asymmetries information. The higher the degree of conservatism will lead to lower this information gap. Research Copeland and Galai (1993) also showed a significant negative influence to the gap on the quality of financial reporting information. Likewise with the results of research conducted by Fanani (2009) showed that the results were negative influences. Results of previous study were as addressing the negative influence on the information gap, meaning that the quality of financial reporting gives undue influence to the information gap caused by the party seeking beneficial for yourself, so that in itself will reduce the information gap. When a quality reporting, the information obtained between internal and external parts will draw. Research conducted by Lafond and Watts (2006) who explains that conservatism reduces asymmetries information by providing constraints to the management in using the information they have.

V. Conclusions and Recommendations

5.1 Conclusion

Conclusions from the data analysis are as follows:

1. Asymmetries iinformation can be minimized by the quality of financial reporting. If the quality of financial reporting provide a negative influence on the information gap. This indicates that when the quality of financial reporting increases, the gap has decreased.
2. The financial reporting of acounting-based quality as measured by persistence and predictability is not affect the information gap because they have greater significant value than 0.05, while the indicator for income smoothing effects on the gap of information because it has a smaller value than 0.05.
3. The financial reporting of Market-based quality as measured by the value relevance and appropriateness of the gap does not affect the value of information as having significantly greater than 0.05, while for indicators of conservatism affect the information gap because it has a smaller value than 0.05.

5.2 Limitations

The author is aware that there are shortcomings in the study. The limitations in this study is the period used in this study is quite short at only five years of data collected thus less able to answer the problem formulation better. Furthermore, there are several companies that can be used for additional samples, but researchers found it difficult to access the company's annual report, so that in the end some of these companies should be excluded from the sample.

5.3 Suggestion

Researchers can add other variables that may affect or reduce the asymmetries information, such as accruals quality one.

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