THE MEDIATING EFFECT OF FINANCIAL REPORTING QUALITY ON THE RELATION BETWEEN CORPORATE GOVERNANCE MECHANISM AND THE STOCK PRICE OF CONSUMER GOODS INDUSTRY LISTED IN INDONESIA STOCK EXCHANGE

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ABSTRACT

The aim of this research is to investigate how Financial Reporting Quality affects the relationship between Corporate Governance Mechanism and stock price of the consumer goods industry listed in Indonesia Stock Exchange. The proxy of Corporate Governance Mechanism are: Institutional Ownership, Managerial Ownerhip, Proportion of the Board of Directors. In this study, 30 firms are investigated during 2010-2013. Path Analysis is used to analyze the direct and indirect relationship among the variables. The result shows that there is no direct and indirect effect of the Corporate Governance Mechanism to the stock price, but there is a direct effect of managerial ownership to the financial reporting quality. The result implies that the stock price is not influenced by the financial reporting quality and corporate governance mechanism. There is another analysis that could be used by investors, such as technical analysis.

Keywords: Corporate Governance Mechanism, Financial Reporting Quality, Stock

1. Introduction

Corporate Governance as one of the key elements in improving economic efficiency, which includes a set of relationships between the company's management, board of directors, shareholders and other stakeholders. Corporate governance also provides a structure to facilitate the determination of the goals of a company and as a means of work monitoring (Deni et al., 2004). Corporate Governance is a concept based on the agency theory, and is expected to serve as a tool to provide confidence to investors that they would receive a return on the funds they have invested.

Corporate Governance is concerned with how the investors believe that managers will benefit them, confident that the manager will not steal / embezzle or to invest in projects that are not profitable, relating to funding / capital that has been invested by the investor, and is concerned with how investors control managers

Corporate governance mechanism oversees the management and decision makers, making it easier to maximize the value of the company. Some matters relating to corporate governance mechanisms are managerial ownership, institutional ownership, and the role of the board of directors.

Dechow, et al. (1996) and Beasley (1996) found a significant relationship between board roles in financial reporting. They found that the size and independence of the board affect their ability to monitor the financial reporting process. GCG implementation is necessary to fulfill the trust and the international community as an essential condition for industrial world to develop well and healthy eventual goal to realize stakeholders' values.

There are five key principles contained in the GCG,: Transparency, accountability, responsibility, fairness, and independency (Daniri, 2006). Some matters relating to corporate governance mechanism are managerial ownership, institutional ownership, and the role of the board of commissioners. To minimize agency costs, can be done in different ways: first, increase managerial ownership, so that the interests of the owners or shareholders will be aligned with the interests of the manager. Second, it can be done through the ownership by institutional investors (Jensen & Meckling, 1976). Moh'd, et al. (1998) suggest that institutional investors are the ones that can monitor an agent with a large stake, so the motivation of managers to manage earnings is reduced. Third, it can be executed through the role of monitoring by the board of directors, where the size and the board independence affect their ability to monitor the financial reporting process. The greater the number of board members, the easier to control and monitoring conducted by the CEO will be more effective (Coller & Gregory, 1999).

Financial reporting connected the people that involved in corporate governance such as the management, including the board of directors, auditors, information distributors, analyst and shareholders. It becomes a bridge and communicates the company with external parties and will be a measurement to determine the performance or outcome of the company (Norwani et al., 2011). The integrity of financial reporting relies on corporate governance. The failure of corporate governance led to failure in financial reporting (Norwani et al., 2011).

Good Corporate Governance is a corporate set up leads to maximize that value of the shareholder, legally, ethically and on a sustainable basis, while ensuring equity and transparency to every stakeholder: the company customers, employees, investors, vendor partners, the government of the land and the community (Murthy, 2006). Corporate governance became a determinant to many subjects in identifying company's strengths and functions. One of the most important functions that corporate governance can play is ensuring the quality of the financial reporting process (Cohen et al., 2004).

The movements of stock markets are determined by various factors, including overall ecnonomy, inflation, trading strategies, return on equity (ROE), market sentiment, and the firm itself (Zhao et al., 2011). The research result of Lai (2010) shows that firms with a higher degree of information transparency yield a higher abnormal return on their stock prices.

The Stock price of a company shows value of investments in companies. The high and the low price of a company stock are affected by many factors such as company performance, risk, dividends, interest rates, supply, demand, inflation, government policies and economic conditions. Stock price reflects the value of the company in the public opinion. If a company's stock price high, the company's value in the public is also good and vice versa. So, the stock price is important for the company.

2. Theory

Corporate Governance

Corporate governance is a concept based on agency theory, and is expected to serve as a tool to give confidence to investors that they would receive a return. Corporate governance is concerned on how the investors believe that the managers will benefit them , confident that the manager will not steal / manipulated or invested into projects that will not give benefit associated with the fund / capital that has been invested by the investor , and deals with how the investors control managers (Shleifer dan Vishny, 1997)

Corporate Governance Mechanisms monitoring role

Some aspects related to the mechanism of corporate governance is managerial ownership, institutional ownership, the role of the board of commissioners (the number of commissioners as well as the independence of the board of commissioner). To minimize agency costs, it can be done in different ways: first, enlarge stock ownership by management (managerial ownership)) (Jensen & Meckling, 1976), so that the interests of the owners or shareholders will be able to be aligned with the interests of managers. Second, ownership by institutional investors. Moh'd, et al (1998) states that institutional investors are parties that can monitor agent, so the motivation for managers to set the profit is reduced. Third, through monitoring role of the board of directors. Dechow, et al (1996) and Beasly (1996) found a significant relationship between commissioner’s roles and financial reporting. They find that the size and the independence of the board of commissioners hired influence their ability to monitor financial reporting process.

The relationship between corporate governance mechanisms and financial reporting quality

One of the most important functions that corporate governance can play is in ensuring the quality of the financial reporting process (Cohen et al., 2004). Financial reporting connected the people that involved in corporate governance such as the management including the board of directors, auditors, information distributors, analysts and shareholders. It is the bridge that communicates the company with the external parties and will be the measurement to determine the performance or outcome of the company (Norwani et al., 2011)

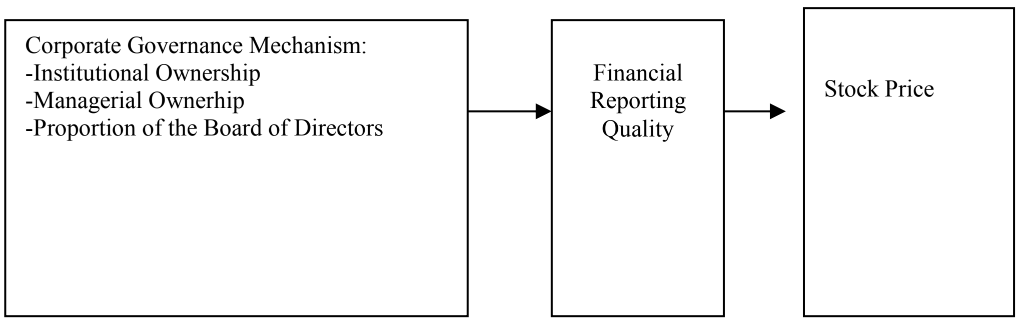
The integrity of financial reporting is highly dependent on the performance and conduct of those involved in the financial reporting ecosystems, particularly directors, management and auditors (Mohd et al.,2008). In other words, the integrity of financial reporting relies on corporate governance (Norwani et al., 2011).

The relationship between financial reporting quality and stock prices

Utami and Suharmadi (1998) in Subekti (2005) investigated the effect of information on the company's earnings share price on the JSE concluded that income information given by the company has the influence on the stock price on the JSE. In this case, stocks that have unexpected income generate positive abnormal return greater than stocks that have unexpected income negative, so that the greater the level of the income, the more optimistic the investors to return to the company. This research also concluded that by announcement of financial statements, CAR (cumulative abnormal return) rises, but after the financial statements announced, CAR decreases. That is why, after the financial statements investors no longer published earn abnormal returns.

Restuningdiah research results (2011) indicate that income smoothing has a significant effect to the market response. The negative coefficient indicates that the high income smoothing, the lower response in the market-proxy the cumulative abnormal return. It shows that investors respond to the information profit corporation in details.

Figure 1. Conceptual Framework of the Mediating Effect of Financial Reporting Quality on the Relation Between Corporate Governance Mechanism and the Stock Price



3 Hypothesis development
According to theoretical framework, firms with high Corporate Governance Mechanism provide high quality financial information and consequently influence stock price. The proxy of Corporate Governance Mechanism are: Institutional Ownership, Managerial Ownerhip, Proportion of the Board of Directors, The hypotheses are:
H1. Institutional Ownership has a significant effect on financial reporting quality
H2: Managerial Ownerhip has a significant effect on financial reporting quality
H3: Proportion of the Board of Directors has a significant effect on financial reporting quality
H4: Financial reporting quality has a significant effect on stock price
H5: Institutional Ownership has a significant effect on stock price through the financial reporting quality
H6: Managerial Ownerhip has a significant effect on stock price through the financial reporting quality
H7: Proportion of the Board of Directors has a significant effect on stock price through the financial reporting quality

4.Research Methods

The population of the study consists of the consumer goods industry listed in Indonesia Stock Exchange during 2010-2013.
The sampling method is purposive sampling. The sample firms must have the following characteristics:
1. The Company has issued financial statements for the period 2010-2013
2. Financial statements ended on December 31,
3. Closing Price of stock period December 31, 2010 -2013 are available
4. The company has institutional ownership, managerial ownership, and independent directors.
Based on the existing criteria, 31 food and beverage companies are selected.
The type of data in this study is secondary data, such as Corporate Governance Mechanism (Institutional Ownership, Managerial Ownership. Proportion Of The Board Of Independent Directors) data, the audited financial statements, and Stock Price (data obtained from www. Idx.co.id).

VARIABLES DEFINITION AND MEASUREMENT
Institutional Ownership is the percentage of voting rights held by institutions (Beiner et al., 2003). In this study, it is measured using the percentage of shares owned by institutions of the entire outstanding share capital

Managerial Ownership is the number of shares by the management of the entire share capital of the company is managed (Gideon, 2005). In this study, it is measured by the percentage of shares held by the management of the entire outstanding share capital of the company

Proportion Of The Board Of Independent Directors is the independent directors are board members who are not affiliated with management, other board members and controlling shareholders, as well as free from the business relationship or other relationship which could affect their ability to act independently or solely in the interest of the company.
In this study, it is measured using the percentage of board members from outside the company of the whole number of members of the company board

Financial Reporting Quality
In this study, financial reporting quality is measured through accruals quality, based on modified Jones model of Dechow et al. (1995), as follows:

$$\mathbf{TACC_{it}/TA_{it\text{-}1}} = \alpha_1\mathbf{(1/TA_{it\text{-}1})} + \alpha_2\mathbf{(\Delta REV_{it} - \Delta REC_{it}/TA_{it\text{-}1})} \\ + \alpha_3\mathbf{(PPE_{it}/TA_{it\text{-}1})} + \varepsilon_{it} \quad (1)$$

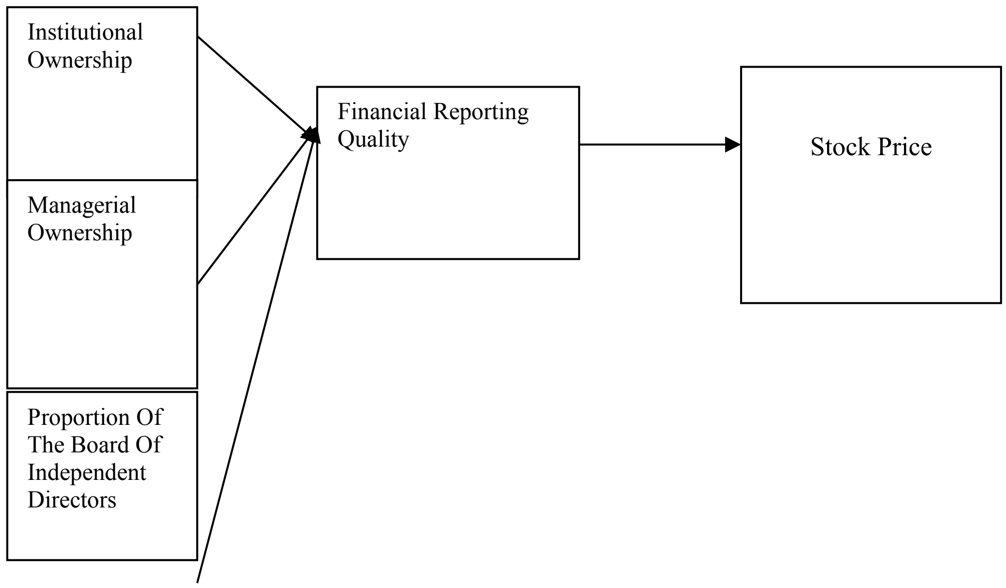
TACC = Total accruals of a given firm in year t (total accruals equal income before extraordinary items less operating cash flows)
TA = Total assets
ΔREV = Change in revenue
ΔREC = Change in receivables
PPE = Gross amount of property, plant, and equipment.

The estimates of α**1,** α**2,** and α **3** obtained from these regressions are then used to estimate discretionary accruals as follows:
DACCit= TACCit/TAit-1 – [α1 (1/TA it-1) + α 2 (ΔREVit- ΔRECit /TA it-1) + α 3 (PPE it /TA it-1)]….(2)
Where:
DACC = Discretionary accruals

Stock Price
Measurement of stock price is the closing price at issuance of audited financial statements

Path analysis is used to test the hypothesis with the following models:

Figure 2. Path Analysis Model of The Mediating Effect Of Financial Reporting Quality On The Relation Between Corporate Governance Mechanism And The Stock Price



$$Z_{FR} = P1\ Z_{IO} + P2\ Z_{MO} + P3\ Z_{PID} + \varepsilon_1$$

$$Z_{SP} = P4\ _{FR} + \varepsilon_2$$

FR = Financial Reporting Quality

IO = Institutional Ownership

MO = Managerial Ownership

PID = Proportion Of The Board Of Independent Directors

SP = Stock Price

4. Result

A. TESTING THE VALIDITY OF THE MODEL

The purpose of testing the validity of the model is to obtain proof of the validity of the research model. The indicator used is the total determination. The total diversity of data that can be explained by the model which are:

$R_1^2 = 0{,}987$ so $P_{e1} = \sqrt{(1 - R_1^{2)}} = \sqrt{(1- 0{,}987)} = 0{,}114$
$R2^2 = 0{,}011$ so $P_{e2} = \sqrt{(1 - R2^2)} = \sqrt{(1- 0{,}011)} = 0{,}994$

For the equation in this study, the coefficient of determination obtained a total of:
$R^2m = 1 - (0{,}114)^2\ (0{,}994)^2 = 1- (0{,}013)\ (0{,}988) = 0{,}99$
The determination value of 0.99 indicates that the diversity of the data that can be explained by the proposed model is at 99% while 1% is explained by other variables that are not included in the model

b. HYPOTHESIS TESTING

Hypothesis	Independent Variable	Dependent Variable	Intervening Variable	Effect	Coefficient path (Sig p)	Explanation
H1	Institutional Ownership	Financial Reporting Quality	-	Direct	,000 (,995)	Not Significant
H2	Managerial Ownership	Financial Reporting Quality	-	Direct	0,993 (0,000)	Significant
H3	Proportion Of The	Financial	-	Direct	-0,001	Not Significant

	Board Of Independent Directors	Reporting Quality			(0,974)	
H4	Financial reporting quality	Stock Price	-	Direct	-0,106 (0,578)	Not Significant
H5	Institutional Ownership	Stock Price	Financial Reporting Quality	Indirect	0,000	Not Significant
H6	Managerial Ownership	Stock Price	Financial Reporting Quality	Indirect	-0,105	Not Significant
H7	Proportion Of The Board Of Independent Directors	Stock Price	Financial Reporting Quality	Indirect	0,000	Not Significant

b.1. The influence of GCG Mechanism on Financial Report Quality

The results show that the influence of Institutional Ownership (IO) does not affect the quality of financial reporting (t = -0,007 and sig t = 0,995, sig p > 0,005), so H01 is unrejected. However, the results show that managerial Ownership's significant positive effect on the quality of financial reporting (t = 38,806 and sig t = 0,000, sig p < 0,005), so H02 is rejected. The results also show that the Proportion Of The Board Of Independent Directors (PID) does not affect the quality of financial reporting (t = -0,007 and sig t = 0,995, sig p > 0,005), so H03 is unrejected.

B. The influence of Financial Report Quality on Stock Price

The results show that Financial Reporting Quality (FR) does not affect the stock price (t = -0,562 and sig t = 0,578, sig p > 0,005), so H04 is unrejected

C. The Indirect Effect of GCG Mechanism on Stock Price

The results show that there is no indirect effect of GCG Mechanism on Financial Reporting Quality (FR), so H05, H06 and H07 are unrejected

5. Discussion And Conclussion

The result showed that Institutional Ownership does not have a significant effect on the quality of financial statement. The results show that the high institutional ownership as well as company low institutional ownership, unrelated to the presence or absence of the income smoothing. This result shows that the voting rights held by an institution cannot affect the size of the level of earnings management conducted by the management. It means that the number of shares held by institutions and other financial institutions can not affect earnings management conducted by the company. This result is consistent with Darmawati (2003), who found that there is no evidence of the relationship between management profit and institutional ownership

The result showed that Managerial Ownership has positive significant effect on the quality of financial statement (proxied by earnings management). the higher managerial ownership, the higher the chances in earning management. It can be concluded that the larger managerial ownership will tend to increase earnings management or they can be interpreted that the larger managerial ownership, the lower the quality of financial reporting. Conversely, the smaller managerial ownership will tend to lower earnings management or they can be interpreted that the smaller the managerial ownership, the higher the quality of financial reporting. A manager who is also a shareholder has a personal interest, as wanting a high return on their shareholding in the company. Thus, managers have the opportunity to do earnings manipulation in the form of rising earnings and lowering the income to meet their interests. It is due to information asymmetry, which is a condition in which one party has advantages compared to the other party information (Gumanti 2009). The results of this study are not corresponding with Jensen and Meckling (1976), that stating to minimize agency costs, can be done by enlarging stock ownership by management (managerial ownership)) so that the interests of the owners or shareholders will be able to be aligned with the interests of managers.

The result shows that the proportion of an independent board of directors does not have a significant effect on the quality of the financial statements. There are several reasons underlying this conclusion. First, the appointment of independent directors of the company may be in regulatory compliance only so as not intended to enforce good corporate governance within the company. Secondly, independent directors appointed are people who have high activity outside the company, so they do not have enough time for the company. Third, the independent board's minimum requirement of 30% is not high enough to influence company policy This result is consistent with the research done by Sarkar et al. (2006) which states that the quality of the board directors (not the quantity), that has an effect on earnings management. It is also consistent with the results of research by Restuningdiah (2011). The results of this study show that if the independent board does not have enough time for a company because of his work outside the company, so their presence will not be effective. Likewise with the expertise of independent board also plays a role in the low earnings management

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