

THE EFFECT OF ACCRUAL RELIABILITY, DEBT LEVEL AND CASH FLOW VOLATILITY ON EARNINGS PERSISTENCE

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Abstract:

This research is entitled "The Effect of Accrual Reliability, Debt Level and Cash Flow Volatility on Earnings Persistence". The research question is "Is the persistence of earnings is affected by accrual reliability, debt levels and cash flow volatility? The research objective is to examine empirically the effect of accrual reliability, debt levels and cash flow volatility on the earnings persistence. Accrual reliability, level of debt and cash flow volatility are independent variables in this study while earnings persistence is the dependent variable. This study used secondary data in the form of annual financial statements of sample companies, namely basic industry and chemicals sector companies listed on the Indonesia Stock Exchange for the period 2014-2018. The sample selection method used was purposive sampling method. In total, there were two 12 sample companies in this study. This study used multiple linear regression data analysis technique including classical assumption test, F-statistical test and hypothesis testing. The results showed the accrual reliability and cash flow volatility had no effect on earnings persistence, while the level of debt had a positive effect on earnings persistence, and therefore, the second hypothesis is acceptable.

Keywords:

Earnings Persistence, Accrual Reliability, Debt Level, Cash Flow Volatility



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INTRODUCTION

Every company always strives to make the profits obtained increase from year to year. The company's performance is considered good if the current period's profit is higher than that of the previous period and the current period profit is a guideline for achieving future period profits (Fama, 2012; Jensen, 2005). Accounting profit is used to make decisions in determining management compensation, management performance appraisal, and determination of dividend distribution to shareholders and so on; however, the company may not always achieve the expectation and desire to increase profits (Lidyah, 2018; Sanusi et al., 2015).

Accrual reliability is one of the factors that influence earnings persistence. The cash flow component in earnings has a higher persistence than the accrual component does. The accrual components in the financial statements are divided according to their reliability categories: high, medium and low (Barton, 2011; Iatridis, 2018). Another factor affecting the earnings persistence is the level of debt. The level of debt reflects the amount of debt the company has. Companies having a high level of debt will encourage management to improve company performance so obligations can be paid on time (Saputra, Jayawarsa, et al., 2019; Trisnadewi et al., 2019). The obligations borne by the company require management to generate profits that increase from one period to the next. Cash flow volatility is another factor that affects earnings persistence. Reviewing the company's cash flow is one way for investors to assess the persistence of a company's earnings. Cash flows can be assessed using the volatility of cash flows (Jensen, 2005; Stanojević et al., 2010).

Researches on the factors influencing earnings persistence have been conducted by several researchers. Researchers of the present study conducted journal mapping and found research gaps in previous studies (Scott-Clayton & Zafar, 2019; Sethuraman, 2019). Research gap is a research gap for previous researchers. The research gap found is the one that comes from differences in research results. The existence of gaps in the research results indicates the need for further research. The present research gap will be formulated as a research problem in the present study (Jensen, 2005). Therefore, a study is conducted with the title "The Effect of Accrual Reliability, Debt Level and Cash Flow Volatility on Earnings Persistence in Basic Industry and Chemicals Sector Companies in the Indonesia Stock Exchange for the 2014-2018 Period". Empirically testing the effect of accrual reliability, debt levels and cash flow volatility on earnings persistence in basic industry and chemicals sector companies listed on the Indonesia Stock Exchange for the period 2014-2018 is the aim of the study.

Agency Theory

Agency theory is the contractual relationship between the principal and the agent. Shareholders as principals take notice of the increased financial performance of the company (persistent profit), in this case management as an agent tries their best to obtain persistent profits in order to be responsible to the principal (Whipple, 2018; X. Yang et al., 2019). The relationship between the principal and the agent is expected to maximize the principal's utility and satisfy the agent to receive rewards from the results of the company's management activities (Yolles, 2019). The contract having been agreed upon by the owner and management explains that the compensation received by the management depends on the profit generated. Agency theory (motivation signaling) is used in this study on the grounds that whether the publication of annual financial reports presented by the company is able to provide persistent profit growth signals (Boučková, 2015; Tran, 2019).

- 1. Earnings Persistence :** Earnings persistence is a correction to the earnings expected in the future which is innovated by the current year earnings. In decision making, earnings reporting is very beneficial for stakeholders (Sunani et al., 2015; S. Yang et al., 2018). Investors and creditors look at the current earnings to determine future earnings. To get the right prediction results, quality earnings are very important to avoid mistakes in predicting. One measure that can be used to predict the future earnings is the earnings persistence (Li & Cai, 2016; Scott-Clayton & Zafar, 2019).
- 2. Accrual Reliability :** Found that the accrual component had a positive effect on earnings persistence; if the accrual reliability was lower, the level of earnings persistence would be lower (Barton, 2011; Ugwuanta & Ugwuanyi, 2019). The more reliable the accrual measurement in the financial statements, the higher the persistence of earnings would be (Ellwood & Newberry, 2007; Iatridis, 2018). H1: Accrual reliability has a positive effect on earnings persistence in basic industry sector companies and chemicals on the Indonesia Stock Exchange for the 2014-2018 period.
- 3. Debt Level :** The high level of debt will motivate the company to improve performance and generate high profits. The company generates additional funds to finance operations and develop the company through debt owned by the company (Jensen, 2005; Jensen & Meckling, 1976). This is the reason why the level of debt has an influence on earnings persistence. The level of debt will affect the level of profit in the future when the company performs well or poorly, whereas when the financial condition is normal, this effect cannot be proven (Iatridis, 2018; Trisnadewi et al., 2019). H2: The level of debt (DAR) has a positive effect on earnings persistence in basic industry and chemicals sector companies on the Indonesia Stock Exchange for the 2014-2018 period.
- 4. Cash Flow Volatility :** High cash flow volatility indicates low earnings persistence, because the current cash flow information is difficult to predict future cash flows (Jensen, 2005). The results of research by Jensen (2005) reveal that cash flow volatility has a positive effect on earnings persistence. H3: Cash flow volatility has a positive effect on earnings persistence in basic industry and chemicals sector companies on the Indonesia Stock Exchange for the 2014-2018 period

METHOD

The population in this study are companies in the basic industry and chemicals sector listed on the main board that publish audited annual financial reports and are published on the Indonesia Stock Exchange in 2014-2018 consisting of 35 companies, respectively. The sampling method in this study is purposive sampling, in that, the sample is selected based on certain criteria.

RESULTS AND DISCUSSION

Tabel 1. Multiple Linear Analysis

Model	Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
	B	Std. Error	Beta	t	Sig.	Tolerance	VIF
1 (Constant)	-22,247	11,431		-1,946	0,065		
X1	15,817	14,601	0,122	1,083	0,291	0,692	1,445
X2	190,576	24,388	0,832	7,814	0,000	0,770	1,298
X3	105,193	132,448	0,079	0,794	0,436	0,880	1,137

Based on the test results, the accrual reliability and cash flow volatility variables are not significant. This can be seen from the significance for accrual reliability which is 0.291 and the cash flow volatility has a significance of 0.436, both of which are far above 0.05. Thus, it can be concluded that the earnings persistence variable is influenced by the level of debt with the multiple linear regression equation as follows:

$$Y = -22,247 + 15,817X1 + 190,576X2 + 105,193X3 + e$$

The multiple linear regression equation used in this study is able to explain a constant of -22,247 and shows that if the independent variable is considered constant, the average level of earnings persistence will be -22,247. The coefficient of the debt level variable (X2) is 190.576 and it shows that if the debt level increases

by one rupiah, the persistence of earnings will increase by Rp190.576. Table 1 shows the adjusted R-squared is equal to 0.790 or 79%; it means that the independent variable in the study is able to explain the persistence of earnings by 79%.

Accrual reliability variable has no effect on earnings persistence. Accrual reliability has a significance value of 0.291 which means greater than 0.05 ($0.291 > 0.05$). Therefore, the accrual reliability of a company does not affect their firm's ability to generate persistent earnings (Iatridis, 2018). The absence of the effect of accrual reliability on earnings persistence is due to the weak accrual component, revenue and expenses which are realised in the form of cash and non-cash which are components of profit (Siti-Nabiha et al., 2018). In activities classifying income, expenses and various other transactions, errors and manipulations by management are prone to occur. In addition, investors often only rely on aggregate profit without seeing the components that affect that profit (Arshad et al., 2015; Siti-Nabiha et al., 2018). There is a positive effect of the level of debt on earnings persistence with a significance value ($0.000 < 0.05$); the higher the level of debt the company has, the higher the company's profit persistence will be. A high level of corporate debt will result in the company increasing earnings persistence in order to maintain performance (Deegan, 2013; Saputra, Juniariani, et al., 2019), both in the eyes of investors and auditors (Sarwoko & Agoes, 2014). Thus, the second hypothesis "The level of debt has a positive effect on earnings persistence" can be accepted (Sethuraman, 2019). The cash flow volatility has a significance value of 0.436 which means greater than 0.05 ($0.436 > 0.05$). Therefore, the cash flow volatility variable has no effect on earnings persistence because to measure earnings persistence, information on stable cash flows that have low volatility is needed (Sunani et al., 2015). Basic industry and chemicals sector companies experienced quite drastic fluctuations during 2014-2018; therefore, cash flow also fluctuates in that period, resulting in high levels of cash flow volatility and is difficult to be used as a determinant in determining earnings persistence (Li & Cai, 2016; Scott-Clayton & Zafar, 2019). The third hypothesis is rejected, that is, cash flow volatility has no effect on earnings persistence.

CONCLUSION

In accordance with the results of hypothesis testing, problem formulation and research objectives, the study has the following conclusions:

1. Accrual reliability variable has no effect on earnings persistence in basic industry and chemicals sector companies listed on the Indonesia Stock Exchange for the period 2014-2018.
2. The debt level variable has a positive effect on earnings persistence in basic industry and chemicals sector companies listed on the Indonesia Stock Exchange for the 2014-2018 period.
3. The cash flow volatility variable has no effect on earnings persistence in basic industry and chemicals sector companies listed on the Indonesia Stock Exchange for the 2014-2018 period.

The suggestions on this research are as follows:

1. Data research used contains cross-section data. Data representing various sizes (small, medium, and large). It is recommended that for further research the data is tested after being grouped by size. So there is no outlier data founded, more data used and approaching the population so that the results are more accurate.
2. Furthermore, researchers are expected to expand their research area, not only in *basic industry* and *chemicals* sector companies on the Indonesia Stock Exchange but in the broader sector so that researchers can be generalized.
3. Further researchers should increase the observation period so that the results of the study are more optimal. It aims to be able to know the average changes of independent variables and dependent variables over a longer period of time. So it can be concluded the influence of changes that occur consistently over a longer period of time.
4. Researchers are then expected to consider other variables that may have an influence on dependent and rarely researched variables, such as company value and managerial ownership.

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