

CHAPTER I

INTRODUCTION

1.1 Research Background

Since the first published, a lot of countries have required and permitted the use of International Financial Reporting Standards (IFRS), especially for the publicly listed companies, rather than their local accounting standard. Indonesia still in progress of converging the Local GAAP which is Pernyataan Standar Akuntansi Keuangan (PSAK). Since 2008, The Indonesian Institute of Accountant (IAI) already declared the idea of converging the local accounting standard from PSAK to IFRS. Start from the beginning of 2012, PSAK were already fully converge to the IFRS as of 2009 which means there were still a 3 year gap. By the beginning of 2015 until now, the gap between PSAK and IFRS is only one year. Currently, Indonesia does not have any future plans on the full adoption (i.e., standardization) of international accounting standards. Indonesia's current commitment to international accounting standards is to harmonize by further minimizing differences with PSAK. IAI believes that IFRS would lead to better quality of financial reporting.

There are several benefits of implementing IFRS as international accounting standard into PSAK as our local accounting standard, which are up to rise of the level of accounting practices, reduce the cost of capital of multinational companies,

and also enhance financial reports' quality such as its comparability and transparency. IFRS eliminate certain accounting alternatives thereby reducing managerial discretion which we expected lower the earnings management and thus improve earnings quality.

IFRS is a principle based standard which only regulate the principle not the detail. Therefore, the IFRS practices will need the professional judgment. An accountant should have the sufficient knowledge, skill and also the ethics to implement the IFRS in order to fulfilling the professional judgment, or in other hand, it may lead to more management discretion. IFRS also arrange the wider use of fair value, for instance the fair value of the biological assets, fixed assets, investment properties, and intangible assets. There are more estimations and judgment that should be made in IFRS practices. IFRS also regulate more disclosure so that users of financial reports will having more considerations about the financial information to make decisions. The agency relationship conflicts may arise due to information asymmetry and opportunistic behaviors which are result of the need of more professional judgment from the managers.

The information asymmetry and opportunistic behaviors were contrast with the expectation that the convergence of IFRS into PSAK will bring the better accounting information quality, more transparency, more reliable, more relevance and better comparability. This contradiction still remains debate. Thus, this research aims to provide more evidence on IFRS convergence in Indonesia would bring higher earnings quality than before.

There are many properties of earnings quality as Dechow et al. (2010) mentioned that the properties of earnings, includes earnings persistence and accruals; earnings smoothness; asymmetric timeliness and timely loss recognition; and target beating. Jaweher and Mounira (2014) focused on 8 different properties which are value relevance, predictability, persistence, timeliness, timely loss recognition, smoothing, earnings toward target, and accruals quality. Francis et al. (2004), they identify two main categories for earnings quality measures: 1) accounting-based measures which use only accounting information and 2) market-based measures which use market and accounting information. Accounting-based attributes take cash or earnings as the reference construct and use only accounting information. Market-based attributes take market returns or market prices as the reference construct, and measures are based on the estimated relation between earnings and market information.

This research will use the earnings management as our metrics to compare before and after the IFRS convergence into PSAK, which is the accounting-based measures. This research will compare the residual value of the accrual and cash flow regression towards the control variables to find the differences. As we know that there are several reasons why IFRS might increases yet decreases the earnings quality by the earnings management as the professional judgment which increases the earnings management opportunities, but in the other hand, the elimination of several accounting alternatives which results in fewer way to managerial discretions.

By a higher quality standard we mean a standard that either reduces managerial discretion over accounting choices or inherently disallows smoothing or overstatement of earnings. Earnings quality and earnings management has a negative relation since the earnings management simply means the managerial discretion. Thus, the higher the earnings management will results in lower earnings quality. If IFRS are of higher quality than PSAK then we expect that adoption of IFRS to improve earnings quality, which also means that we expect the lower earnings management after the IFRS convergence than before IFRS convergence. To measure the earnings management as our proxy, this research will use the model from Chua et al. (2012) framework.

This research aims to determine whether IFRS adoption leads to higher earnings quality of listed manufacturing companies in Indonesia Stock Exchange (IDX). We will observe the relevance of the financial report from 3 years pre-IFRS convergence (2005-2007) and 3 years after IFRS full convergence (2012-2014). There is a 4-year-gap in between the sample period because this is the preparation of IFRS implementation period. Previous research in Indonesia that attempt to study the impacts of the IFRS convergence on earnings quality using the pre-IFRS convergence as year before 2008 and the post-IFRS as year after 2012 is relatively small in number. Most researches study the pre-IFRS period whether in year before 2011 as the final stage of IFRS implementation or before the year 2012 as the year of full IFRS convergence. We use the 3 years before 2008 as the pre IFRS convergence period because we assume that there is no company that voluntary

implement the IFRS in reporting their financial statements in those years. Companies in manufacturing sectors are the sample of this research as this sector is the largest in population among other sectors.

1.2 Research Question

Indonesian accounting regulator has decided to implement the IFRS into PSAK with the belief that higher quality of accounting regulation will also bring higher quality of accounting practices, including the financial statements of the companies. We believe that earnings quality would also be higher than before the IFRS convergence. Since there are many proxies of earnings quality, this research will analyze the impact of IFRS convergence on earnings quality based on earnings management level in Indonesia. Thus, the research question of this research is whether there is a difference in earnings management level between before and after IFRS convergence into PSAK for listed manufacturing companies in IDX or not.

1.3 Research Objective

This study aims to analyze and also to give empirical evidence whether there is a significant difference of earnings quality in the determined proxy which is earnings management between before IFRS convergence into PSAK and after IFRS convergence into PSAK for listed manufacturing companies on IDX.

1.4 Research Contributions

This study results hopefully will be useful for:

a. Investors and creditors

This study will show the investors and creditors about whether the earnings quality were better than before as they were the main users of the company financial reports and the earnings quality might show how deep the investors and creditors can rely on the numbers in financial reports.

b. Theoretical development

This study might develop the knowledge about the impact of IFRS convergence on the earnings quality in Indonesia based on the earnings management. Hopefully this study can also give information for other researchers in the same field of research.

1.5 Data Analysis

In analyzing data for this research, the researcher gradually conducted the following steps:

1. Gather the list of listed companies in IDX since 2005 until 2014.
2. Elect companies based on the sample criteria.
3. Collect all the financial statements of the sample from year 2005-2007 and 2012-2014.
4. Gather all required financial data to measure the earnings management as our proxy of earnings quality.

5. Measure the earnings quality using the Spearman correlation test between the residual of total accrual and operating cash flow.
6. Conduct the hypothesis testing using a paired difference t test.
7. Interpret and analyze the results.

1.6 Systematic Content

CHAPTER I : INTRODUCTION

This chapter describes the background of the research, main questions of the research, objectives of the research, contribution of the research, data analysis process of the research, and systematic writing of the contents of the research.

CHAPTER II : THEORITICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

This chapter consists of relevant theories, concepts, and literature about IFRS convergence and earnings quality. Further, it presents several related previous research which will be used as a reference in hypothesis development and discussion of the data analysis results.

CHAPTER III : RESEARCH METHODOLOGY

This chapter explains the methods in selecting and sampling the data population, collecting the financial information,

define earnings management as our proxy to measure earnings quality, and analyzing the data.

CHAPTER IV : DATA ANALYSIS AND DISCUSSION

This chapter presents the results from data analysis and the discussion of the results based on the hypothesis and previous research.

CHAPTER V : CONCLUSION

The final chapter presents several conclusions based on the hypothesis and results. It will also indicate the limitations of the research and include several suggestions for future research.

