CHAPTER II

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Financial Reporting

Financial report is a structured presentation of financial position and financial performance of an entity. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful for existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity (IASB 2010, paragraph OB2). Financial reports provide information about the reporting entity's economic resources, claims against the reporting entity, and the effects of transactions and other events and conditions that change those resources and claims (IASB 2010, paragraph QC2).

The types of information that are likely to be most useful to the existing and potential investors, lenders, and other creditors for making decisions about the reporting entity in its financial report (financial information) has been expressed in chapter 3 of Statement of Financial Accounting Concepts (SFAC) No. 8 (IASB 2010) as the qualitative characteristics of useful financial information. The qualitative characteristics of useful financial information based on Conceptual Framework for Financial Reporting from SFAC No.8 (2010) are:

1. Fundamental Qualitative Characteristics

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent.

a. Relevance

Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already are aware of it from other sources. (IASB 2010, paragraph QC6)

b. Faithful representation

Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral, and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible. (IASB 2010, paragraph QC12)

2. Enhancing Qualitative Characteristics

Enhancing qualitative characteristics are characteristics that enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics also may help determine which of two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented. (IASB 2010, paragraph QC19)

a. Comparability

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. (IASB 2010, paragraph QC20-21)

b. Verifiability

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. (IASB 2010, paragraph QC26)

c. Timeliness

Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends. (IASB 2010, paragraph QC30)

d. Understandability

Classifying, characterizing, and presenting information clearly and concisely makes it understandable. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading. (IASB 2010, paragraph QC30-31)

2.2 International Financial Reporting Standard

The quality of financial reporting could be measured by its qualitative characteristics. High quality accounting standard can deliver the high quality of financial reporting. In order to achieve this global objective, the International Accounting Standards Board (IASB) was formed in 2001 to replace International Accounting Standards Committee (IASC) which is an independent standard setter for the private sector founded in 1973 by the organization of accounting professionals in nine countries. Effective from 1 December 2016, IASB normally has 14 board members, of whom one is appointed as Chair and one as Vice-Chair. IASB members are appointed for an initial term of five years. Terms are may be renewable once for a further term of three years, with the possibility of renewal up to a maximum of five years, in line with procedures developed by the Trustees for such renewals, however, the terms may not exceed 10 years in total length of service as a member of the Board. The IASB operates under the oversight of the IFRS Foundation.

In 2003, IASB published the first standard of International Financial Reporting Standards (IFRS), IFRS 1–First-time Adoption of IFRSs. IFRS is a single set of accounting standards developed and maintained by the IASB to provide a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. IFRS issued with the intention of those standards being capable of being applied on a globally consistent basis—by developed, emerging and developing economies—thus providing investors and other users of financial statements with the ability to compare the financial performance of publicly listed companies on a like-for-like basis with their international peers.

2.3 IFRS Convergence in Indonesia

Together with the aim of IASB is to develop a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles (IASB, 2014), Ikatan Akuntan Indonesia (IAI) decided to use the IFRS instead of US GAAP as the basis for developing SAK. The public commitment to converge IFRS into PSAK was made on 8 December 2008. Consequently, SAK has been continuously developed and revised through several improvements and additions to fully harmonize and converge with IFRS.

According to Lestari (2011), the harmonization with IFRS has undergone two phases in Indonesia up to 2012; the first phase occurring before the issuance of new standards under IASB in which SAK issued and revised was mainly-based on IAS, and the second phase occurring afterwards when SAK is fully-based on the new set of IFRS.

The DSAK-IAI has currently finished working with a third IFRS convergence process with the objective to further minimize the differences between SAK and IFRS, from three years to one year. SAK effective as of 1 January 2012 is substantially harmonized with IFRS effective as of 1 January 2009. Currently, SAK effective as of 1 January 2015 is substantially harmonized with IFRS effective as of 1 January 2014, continuously until nowadays.

The following table illustrates the convergence roadmap for IFRS in Indonesia:

Table 2.1
IFRS Convergence Roadmap in Indonesia

Adoption Stage (2008-2010)	Final Preparation Stage (2011)	Implementation Stage (2012)
• Adopt all IFRS to SAK • Required infrastructure preparation. • Evaluation and management of the impacts of adoption to the applicable SAK.	• Required completion of infrastructure preparation. • Phased implementation of several IFRS-based SAK.	• Full implementation of IFRS-based PSAK. • Comprehensive evaluation of the impacts of implementation.

Sources: Lestari (2011)

2.4 Earnings Quality and Measurements

Earnings quality is a tool to measure how relevance the reported income and the real situation. According to SFAC No. 8, the relevancy and faithful presentation might be enhance by comparability, verifiability, timeliness and understandability.

Dechow et al. (2010) define earnings quality by borrowing language from Statement of Financial Accounting Concepts No. 1 (SFAC No. 1) as follows:

> "Higher quality earnings provide more information about the features of a firm's financial performance that are relevant to a specific decision made by a specific decision-maker."

Previous studies in earnings quality indicate many measures or proxies of the variable. This variety is due to the fact that each measure captures a different aspect of earnings quality. Different aspect will also have specific measurement which brings out no specific measurement will suitable for all aspects. Earnings quality attribute to characterize desirable features of earnings which include accrual quality, persistence, predictability, smoothness, value relevance, timeliness, and conservatism (Francis et al., 2004).

In addition, Francis et al. (2004) identified two main categories for earnings quality measures, accounting based and market-based. 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. Earnings management is one of the accounting-based attribute which only use the accounting number in the financial statements. It is naturally has a negative correlation with earnings quality.

Dechow et al. (2010) conducted a more thorough study on the literature of the proxies of earnings quality and identified other measures that are not directly related to the attributes discussed by Francis et al. (2004). The following are the measures of earnings quality summarized by Simarmata (2015):

a. Persistence

Companies with more persistent earnings have more sustainable earnings and are viewed as desirable because they are recurring. Persistence can be achieved in the short run by engaging in earnings management and thus the measure is often more useful for long term evaluation.

b. Predictability

Predictability is a measure of earnings quality based on the ability of earnings to predict itself.

c. Magnitude of accruals

The level of accruals can be measured by a variety of models with the most common being a measure of separating cash flow revenues from earnings. High levels of accruals are low quality because they represent a less persistent component of earnings or are less representative of cash flows.

d. Accruals quality

Accruals quality takes the view that reported earnings which have proximity with reported cash flows are desirable. Dechow and Dichev (2002) conducted a study in which accruals are modeled as a function of past, present, and future operating cash flows. Accruals quality is measured from the residuals of the regressions of changes in working capital on past, present, and future operating cash flows. Higher amounts of residuals indicate lower earnings quality.

e. Abnormal accruals

Abnormal accruals are residuals from accrual models that represent the discretion of management or estimation errors in accounting for accruals. Both reduce the decision usefulness of reported earnings and thus higher amounts of residuals indicate lower earnings quality.

f. Smoothness

Smoothness is viewed as a desirable earnings attribute because it captures the activities of managers using private information about future income to smooth out fluctuations and thus achieve a more representative reported earnings number. Leuz et al. (2003) use two commonly used measures for capturing smoothness, the variability of reported earnings and the changes in accruals.

g. Value relevance

Value relevance is a measurement of earnings quality that examines the ability of earnings to explain variation in returns. Greater explanatory power is viewed as a higher value of earnings quality.

h. Timeliness

Timeliness is an attribute of earnings quality which measures the explanatory power of a reverse earnings-returns regression. A higher result coefficient implies more timely recognition of stock returns, which is affected by bad and good news, in earnings and thus higher earnings quality.

i. Conservatism (Timely loss recognition)

The measure of conservatism differs from timeliness. A measure of conservatism attempts to reflect the difference between the ability of accounting earnings to reflect economics losses and gains.

j. Earnings response coefficients

Earnings response coefficients measure investor responsiveness to earnings based on the theory that investors respond to information that has value implications. A higher output coefficient indicates more informative components of earnings.

k. Benchmarks (target beating)

Target beating is an “unusual” grouping of earnings distributions that indicate engagements in accounting tactics around targets (e.g., a target of zero earnings). For instance, researchers have documented small loss avoidance as a finding in which there are only a small number of firms with small losses and a large number of firms with small profits.

l. External indicators of earnings misstatements

Companies which had accounting errors, restatements, or international control deficiencies in their financial reporting systems imply low earnings quality.

The review of the proxies of earnings quality conducted Dechow et al. (2010) indicate that the most common measure of earnings quality researched is abnormal accruals. As for this research, we will use the timeliness and conditional conservatism (timely loss recognition) as our measurements of earnings quality.

2.5 IFRS Convergence and Earnings Quality

By adopting IFRS, a business can present its financial statements on the same basis as its foreign competitors, making comparisons easier. Furthermore, companies with subsidiaries in countries that require or permit IFRS may be able to use one accounting language company-wide. Companies also need to convert into IFRS if they are a subsidiary of a foreign company which is mandatory to use IFRS. Companies may also benefit by using IFRS if they wish to raise capital abroad to attract the foreign investors by reporting in the international standards.

IFRS might reduce the accounting alternatives, limit the management's opportunistic discretion, and demand broader disclosure. Before the IFRS convergence, managers have more flexibility to choose the accounting methods or change the accounting policies to increase, decrease, or smooth the income. This flexibility might lead to less relevance income number which might not describe the good news and bad news in a timely manner. Thus, we expect that IFRS as the global accounting standards might bring more relevance earnings in timelier manner.

Sinaga (2012) mention that the effect of IFRS convergence leads SAK experience some changes as from rule based into principle based, broader fair value, requirements of professional judgments, and more disclosures.

2.6 Earnings Management as a Proxy of Earnings Quality

Schipper (1989) defines earnings management as purposeful intervention in the external financial reporting process, with the extent of obtaining some private gain, as opposed to merely facilitating the neutral operation of the process. Earnings management is basically: (1) an attempt to provide misleading information about the company's economic performance to stakeholders, and (2) an effort to influence contractual outcomes that depend on accounting numbers reported (Healy and Wahlen, 1999). The lower the level of earnings management, the higher the quality of financial statements for company.

Even there are a lot of earnings management proxies, Zeghal et al. (2012) focus on four aspects of earnings management, which are earnings smoothing, managing toward small positive earnings, accruals quality and the magnitude of absolute of discretionary accruals. In this research, we will use the earnings smoothing as our proxy. As an indicator of earnings quality, smoothness reflects the extent to which accounting standards allow managers to reduce the variability of reported earnings by altering the accruals, presumably to obtain some capital market benefits associated with a smooth earnings stream (Leuz et al., 2003 in Zeghal et al., 2012). This measure also attempts to capture accrual quality (Francis et al., 2004). Under this view, smoother earnings would imply lower quality earnings.

2.7 Previous Researches

The beliefs that IFRS would increase the earnings quality has been the most questionable issues since it was the main purpose of IFRS establishment. Barth et al. (2008) provide international evidence that the voluntary adoption of International Accounting Standards (IAS) is associated with higher accounting quality, less earnings management, more (less) timely loss (gain) recognition, and more value-relevant accounting information. Barth et al. (2010) examine whether IFRS adoption has made the financial statements of non-U.S. firms more comparable to the financial statements of U.S. firms. They find some evidence that, compared to domestic GAAP, IFRS increases comparability with U.S. firms. Ahmed et al. (2013) investigate the mandatory adoption of IAS in a similar setting as Barth et al. (2008), but document the results in contrast to the findings of earlier studies. They document more earnings management, less timely loss recognition, and more earnings smoothing after the adoption of IAS.

Jaweher and Mounira (2014) examining a different setting in Australia and Europe with a different time frame from 2001 until 2010. They provide the evidence that reported earnings are no more value relevant and weaker timely loss recognition in the post adoption period. Nevertheless, accounting numbers under IFRS generally exhibit more persistence and timeliness earnings compared to those under Australia and Europe GAAP regulation. In contrast, Zeghal et al (2012) show results that European firms exhibit less value relevance, less timeliness, and less conditional conservatism of accounting numbers after the application of IFRS. They found that firms exhibit an increase in the accounting-based attributes, but a decrease in the market-based after the adoption of IFRS in European Union (EU) start from 2005.

Liu et al. (2011) examine the effect of IFRS-based accounting standards on earnings quality operationalized with earnings management, and value relevance measures. Results of these measures show consistency with Barth et al. (2008) that earnings quality improved with decreased earnings management and increased value relevance of accounting measures in China since 2007. Similar with Indonesia, China local accounting standards are also substantially converged with international standards. Their local standards are being continuously converged with international standards with no future plan of full adoption.

There are still few studies about the effect IFRS convergence in Indonesia. Previous research was gathered selectively on the basis of providing evidence for the IFRS convergence that has been fully implemented as of 2012. However, most of the research available and gathered provides evidence on the effect of the phased pre-implementation of IFRS as of 2008-2011 which Indonesia was still in the process of converging the IFRS.

Claudya (2014) examine the earnings management with earnings smoothness by using the sample from LQ45 companies from year 2006 and 2007 as the pre-IFRS convergence and 2011-2012 as the post-IFRS convergence. Evidence suggests IFRS convergence does not generally improve earnings quality. Bangun (2014) suggests that there is a difference in earnings quality before and after IFRS convergence operationalized by discretionary accruals. Sianipar and Marsono (2013) provide evidence on the effect of the full implementation of IFRS convergence. Findings indicate that the full implementation of IFRS convergence does not result in a significant different in value relevance, timely loss recognition, and discretionary accruals. It is important to note that the time frame of this study is only two years long.

Taken together, these studies offer mixed evidence regarding the effects of the mandatory adoption of IFRS on earnings quality with several proxies and time frames.

2.8 Hypothesis Development

There are series of empirical papers examining properties of earnings quality. Dechow and al. (2010) stated that researchers have used various measures as indications of earnings quality including persistence, accruals, smoothness, timeliness, loss avoidance, investor responsiveness, and external indicators such as restatements and SEC enforcement releases. The empirical literature has developed several metrics to proxy earnings quality. These metrics are based on the qualitative characteristics in the conceptual framework. More explicitly, the IASB conceptual framework categorizes the qualitative characteristics of useful financial information into fundamental and enhancing qualitative characteristics. The fundamental qualitative characteristics are relevance and faithful representation while comparability, verifiability, timeliness, and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

In this research we will use earnings management as our proxy to measure the earnings quality. As an indicator of earnings quality, smoothness reflects the extent to which accounting standards allow managers to reduce the variability of reported earnings by altering the accruals, presumably to obtain some capital market benefits associated with a smooth earnings stream (Leuz et al., 2003 in

Zeghal et al., 2012). This measure also attempts to capture accrual quality (Francis et al., 2004). Under this view, smoother earnings would imply lower quality earnings. Since IFRS convergence into PSAK believed will enhance the accounting quality, we also expect that IFRS convergence into PSAK will also enhance earnings quality.

In the other hand, IFRS as a principle based standard needs more professional judgment in the practices. This situation tends to encourage the accountant to do the earnings management as their opportunistic behavior. The extensive use of fair value is also a contradiction to the higher earnings quality. There are many methods to determine the fair value. Managers are sometimes tends to choose among the accounting alternatives to affect the earnings to pursue their objectives.

Because of the contradiction of those situations, we formulate our alternate hypothesis as below.

Ha: There is a difference in earnings management between before and after IFRS convergence.