

CHAPTER II

LITERATURE REVIEW

2.1. Accounting Standard

2.1.1. Indonesian Accounting Standard Development

Indonesia has been through some stages of accounting standard development. The accounting standard development is as follows.

1. Period of 1973-1984

The Indonesian Institute of Accountants (Ikatan Akuntansi Indonesia or IAI) already set up a committee that was authorized to formulate accounting standards. This standard was known as the Indonesian Accounting Principles (Prinsip-prinsip Akuntansi Indonesia or PAI).

2. Period of 1984-1994

The Committee of Indonesian Accounting Principles replaced PAI 1973 with PAI 1984. At the end of 1994, The Committee of Indonesian Accounting Principles made a significant revision of Indonesian accounting principles with formulating Statements of Financial Accounting Standards (PSAK). The revision resulted 35 Statements of Financial Accounting Standards (PSAK), that most of them were harmonized with the International Accounting Standard (IAS) by International Accounting Standard Board (IASB).

3. Period of 1994-2004

Starting on 1994, the Committee of Indonesian Accounting Principles started to use International Accounting Standards as the basis for formulating financial accounting standards in Indonesia. On 1995, IAI did a revision to apply new standards that most of them were consistent to IAS. Some standards were adopted from US GAAP and the rest were formulated due to Indonesian specific case.

4. Period of 2006-2008

During 1995 until 2010, the Financial Accounting Standard had continuous revisions. These revisions included additional standards and formulation of new standards. The revisions were done at October 1 1995, June 1 1999, April 1 2002, October 1 2004, June 1 2006, September 1 2007, and July 1 2009. At the tenth congress meeting of the Indonesian Institute of Accountants held in Jakarta at 2006, it was planned that a full convergence process will be done in 2008.

However, the adoption process was finally being started at 2012.

2.1.2. International Financial Accounting Standard (IFRS)

The International Financial Accounting Standard (IFRS) is a globally-accepted accounting standard issued by the International Accounting Standard Board (IASB). IASB is organized under an independent foundation named the IFRS foundation. The foundation is a not-for-profit corporation which was created under the laws of the State of Delaware, United States of America on March 2001. Starting on 2001, the IASB replaced the International Accounting Standards Committee (IASC)

which was formed in 1973. Until March 31 2010, the IFRS Interpretations Committee was named the International Financial Reporting Interpretations Committee (IFRIC). IFRIC replaced the Standards Interpretations Committee (SIC) of the IASC with effect from 1 April 2001. The SIC was part of the original IASC structure formed in 1973 (Deloitte, 2014).

The IASB engages closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession. Its members (currently 16 full-time members) are responsible for the development and publication of IFRSs, including the IFRS for SMEs and for approving Interpretations of IFRSs as developed by the IFRS Interpretations Committee (IFRS, 2014). The IASB develops its standard by conducting an extensive due process, which is founded on the principles of transparency, full and fair consultation, and accountability (IFRS, 2014). The IFRS are now used in more than 100 countries, including three quarters of the G20 and all the Member States of the European Union (IFRS, 2014).

Consistent with the long-term objective of IASB, IFRS purport to be a set of high-quality accounting rules that would ideally be applied consistently by public companies globally to ensure that they are acceptable by the capital markets around the world (IASB 2009 in Chua et al. 2012). While there is no consensus as to what constitutes high-quality accounting standards, IFRS are perceived to be high quality because they

represent a collection of the world's best accounting practices and are purported to be more capital oriented than many domestic accounting standards (Ding et al. 2007 in Chua et al. 2012). The goal of IFRS is to provide a global framework for how public companies prepare and disclose their financial statements. IFRS provides general guidance for the preparation of financial statements, rather than setting rules for industry-specific reporting.

2.1.3. IFRS Adoption in Indonesia

At December 23, 2008 the Indonesian Institute of Accountant stated that the Indonesian Accounting Standard will be converged to IFRS as of 2012. There are two adopting strategies for IFRS convergence; *big bang strategy* and *gradual strategy*. *Big bang strategy* (also known as *shock therapy* or *cold turkey*) is a simultaneous and quick implementation of all (transition) reforms. In other words, the *big bang strategy* is fully adopting IFRS without going through some phases. This strategy usually been chosen by advanced countries such as Australia. The adoption process by *gradual strategy* on the other hand, is done through some phases of adoption. The Financial Accounting Standard Board (Dewan Standar Akuntansi Keuangan or DSAK) stated that there are five level of IFRS adoption.

1. Full Adoption

Is the degree of IFRS adoption where a country fully adopting, translating, and apply IFRS.

2. Adopted

Is a degree of adoption where IFRS is adjusted to the specific condition of the country. In other words, it is possible for the country to have several standards from IFRS being adjusted to its specific economic conditions, and some are not.

3. Piecemeal

A country adopts only the big points of IFRS and chooses only certain paragraphs which are suitable with the country's condition.

4. Convergence

A country takes only specific standards of IFRS and compile them with its own language and make it into paragraph.

5. Not adopted at all

A country does not adopting IFRS at all.

The Indonesian Accounting Standard was converged to IFRS through three steps. Below is the roadmap of IFRS convergence.

Table 1

Roadmap of IFRS Convergence into PSAK

Adoption Stage (2008-2010)	Preparation Stage (2011)	Implementation Stage (2012)
Adopting all IFRS to SAK	Finalizing the necessary infrastructure	Implementing of the standards

Adoption Stage (2008-2010)	Preparation Stage (2011)	Implementation Stage (2012)
Preparing the necessary infrastructure	Phased implementation of some of IFRS-based PSAK	Evaluating of the impact to business environment
Evaluating and managing the adoption impact		

The benefits that Indonesia achieves by adopting IFRS are as follows.

1. Increase the quality of financial reports and decrease the possibility of asymmetric information.
2. Enhance the comparability because financial statements are prepared based on international standard which support understandability of available information.
3. Support global investing climate.

Below is the table of number of PSAK and their effective dates. The table below is used as a basis of determining years used in sample period after IFRS adoption.

Table 2

Effective Date of IFRS-based PSAK

Effective date	PSAK number
January 1 2011	<ul style="list-style-type: none"> - PSAK 1: Penyajian Laporan Keuangan - PSAK 2: Laporan Arus Kas - PSAK 3: Laporan Keuangan Interim - PSAK 4: Laporan Keuangan Konsolidasian dan Laporan Keuangan Tersendiri - PSAK 5: Segmen Operasi - PSAK 7: Pengungkapan Pihak-pihak Berelasi - PSAK 8: Peristiwa Setelah Periode Pelaporan - PSAK 12: Bagian Partisipasi dalam Ventura Bersama - PSAK 15: Investasi pada Entitas Asosiasi - PSAK 19: Aset Tak Berwujud - PSAK 22: Kombinasi Bisnis - PSAK 23: Pendapatan - PSAK 25: Kebijakan Akuntansi, Perubahan Estimasi Akuntansi, dan Kesalahan - PSAK 48: Penurunan Nilai Aset - PSAK 57: Provisi, Liabilitas Kontijensi,

Effective date	PSAK number
	<p>dan Aset Kontijensi</p> <ul style="list-style-type: none"> - PSAK 58: Aset Tidak Lancar yang Dimiliki untuk Dijual
January 1 2012	<ul style="list-style-type: none"> - PSAK 10: Pengaruh Perubahan Kurs Valuta Asing - PSAK 13: Properti Investasi - PSAK 16: Aset Tetap - PSAK 18: Akuntansi dan Pelaporan Program Pembuat Manfaat Purnakarya - PSAK 24: Imbalan Kerja - PSAK 26: Biaya Pinjaman - PSAK 28: Akuntansi Kontrak Asuransi Kerugian - PSAK 30: Sewa - PSAK 33: Aktivitas Pengupasan Lapisan Tanah dan Pengelolaan Lingkungan hidup pada Pertambangan Umum - PSAK 34: Kontrak Konstruksi - PSAK 28: Akuntansi Kontrak Asuransi Jiwa - PSAK 45: Pelaporan Keuangan Entitas Nirlaba

Effective date	PSAK number
	<ul style="list-style-type: none"> - PSAK 46: Pajak Penghasilan - PSAK 50: Instrumen Keuangan: Penyajian - PSAK 53: Pembayaran Berbasis Saham - PSAK 55: Instrumen Keuangan: Pengakuan dan Pengukuran - PSAK 56: Laba per Saham - PSAK 60: Instrumen Keuangan: Pengungkapan - PSAK 61: Akuntansi Hibah Pemerintah dan Pengungkapan Bantuan Pemerintah - PSAK 62: Kontrak Asuransi - PSAK 63: Pelaporan Keuangan dalam Ekonomi Hiperinflasi - PSAK 64: Pelaporan Keuangan dalam Ekonomi Hiperinflasi

Source: Indonesian Institute of Accountant, 2012

2.2. Financial Reporting

2.2.1. The Objective of Financial Reporting

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions

about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or setting loans and other forms of credit (SFAC No.8 chapter 1: OB2). Decisions by existing and potential investor about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments, or market price increases (SFAC No.8 chapter 1: OB3).

In other words, the primary objective of financial reporting is to provide useful information that is useful for decision making. SFAC 1 articulates this importance of financial reporting through three basic financial reporting objectives. First, financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. The first objective specifies a focus on investors and creditors. In addition to the importance of investors and creditors as key users, information to meet their needs is likely to have general utility to other groups of external users who are interested in essentially the same financial aspects of a business as are investors and creditors (McGraw-Hill, 2007).

Second, Financial reporting should provide information to help present and potential investors and creditors and other users to assess the

amounts, timing, and uncertainty of prospective cash receipts. It means that since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise. This second objective refers to the specific cash flow information needs of investors and creditors (McGraw-Hill, 2007).

Third, financial reporting should provide information about the economic resources of an enterprise; the claims to those resources (obligations); and the effects of transactions, events, and circumstances that cause changes in resources and claims to those resources. This third objective emphasizes the need for information about economic resources and claims to those resources. This information would include not only the amount of resources and claims at a particular point in time but also changes in resources and claims that occur over periods of time. This information is key to predicting future cash flows (McGraw-Hill, 2007).

2.2.2. Asymmetric Information

There are times when markets fail due to imperfect information. The first type of imperfect information is public incomplete information. It means that information is randomly insufficient and not manipulated by any agent in markets, generating inefficient resource allocation and thus creating welfare losses. The second type is asymmetric information (Balkan Conference Operational Research, 2005). In corporate finance, asymmetric information refers to the notion that firm's insiders, typically

managers, have better information than do market participants on the value of their firms' assets and investment opportunities. This asymmetry creates the possibility that the market will not price the firm's claims correctly, thus providing a positive role for corporate financing decisions (Klein, et al. 2002).

Scott (2012) states that there are two types of *Asymmetric Information*; they are:

- *Adverse Selection*

Adverse Selection is a type of *Information Asymmetry* that happens because one or more group in a transaction has more information than the others. There are some ways that a manager can do to beneficially use their information from investors. One of the ways is to manage the flow of information given to investors since that it affects investors' ability to make investment decision.

- *Moral Hazard*

Moral Hazard is a type of *Information Asymmetry* that happens because one or more group in a potential transaction or business transaction is able to monitor how far his decision is going in the business, while the other group can not. This problem emerge because the existence of separation of ownership and control which become the characteristic of most firms.

In practice, there are kinds of information published by firms that influence the price of securities. This information is mostly related to the announcement of events that happens to the firms. Some firms published those information with aim to reduce the asymmetrical information (Thoradewa, 2012).

2.2.3. Efficient Stock Market

Accurate and timely information will be needed by investor in making any investment decision. A market reaction towards that information will be shown by the changes in the stock price whenever information of an event has been announced and being available to the investors. Any events will then be interpreted by the investors as good news or bad news. If the information is good (bad) news then it will trigger an increase (a decrease) in the stock price. Thus, it is logical to argue that information announcement (both economic and non-economic information) is closely related to the stock price changes. And that the price of security is normally to be fluctuated because any information announced will be reflected in the price of the securities by the efficient market.

The *Efficient Market Hypothesis* (EMH) states that price of securities must fully reflect available information about securities (McGraw-Hill, 2003:229). There are three types of EMH which states as follows.

1. *Weak-form Efficiency Theory*

Weak-form Efficiency Theory asserts that stock price already reflect all information that can be derived by examining market trading data such as the history of past prices, trading volume, or short interest. Past stock price data are publicly available and virtually costless to obtain.

2. *Semi-strong Efficiency Theory*

A market has a semi-strong efficiency if prices fully reflect all readily-available public information such as past price, economic views, earnings report. Test of semi-strong efficiency are those that study stock price movements following announcements such as stock splits, earnings announcements, accounting standard used, or merger.

3. *Strong-form Efficiency Theory*

Strong-form Efficiency Theory states that stock price reflects all information relevant to the firms, even including information available only to company insiders.

Semi-strong efficiency theory states that all publicly available information has to represent the real condition of the company, including the past information such as past stock prices and trading pattern, and the information that is published such as the financial statements. Thus, this research is related to the semi-strong efficiency theory since that listed companies in Indonesia also provide investors with annual reports, which

was first submitted to the Indonesian Stock Exchange before being published to investors.

2.3. Return

Return refers to any result obtained from investment activity. There are two types of return; realized return (or actual return) that is already occur and expected return that is not yet occur, but will be occur in future. Realized return is calculated based on historical price. Realized return is important since it measures firm's performance. This historical return is also used as a basis to determine expected return and future risks. Expected return as its name, refers to return that is expected to be achieved by investor in future. It is different from realized return since expected return has not occurred yet (Jogiyanto, 2003:109).

2.4. Abnormal Return

Abnormal return (also called by excess return) refers to any excess of return that occurs towards normal return. Normal return has the same meaning with expected return. Thus, abnormal return is the difference between actual return (or realized return) and expected return (or normal return), formulated as follows.

$$AR_{i,t} = R_{i,t} - E[R_{i,t}]$$

Where:

- $AR_{i,t}$: abnormal return of the i-security at t-period of time
- $R_{i,t}$: actual return of the i-security at t-period of time
- $E[R_{i,t}]$: expected return of the i-security at t-period of time

Actual return (or realized return) is the return that occurs at t-period and refers to the difference between the current relative price and the previous price. It is formulated as follows.

$$R_{i,t} = (P_{i,t} - P_{i,t-1}) / P_{i,t-1}$$

On the other hand, expected return has to be estimated. There are three types of model that can be used to estimate expected return, they are; *mean-adjusted model*, *market model*, and *market-adjusted model* (Jogiyanto, 2003:434).

- *Mean-adjusted Model*

Mean-adjusted model states that the expected return has a constant value which is equal to the previous realized return during estimation period. It is formulated as follows.

$$E [R_{i,t}] = \frac{\sum_{i=t_1}^{t_2} R_{i,j}}{T}$$

Where:

$E[R_{i,t}]$: expected return of the i-security at t-period of time

$R_{i,j}$: realized return of the i-security at j-period of time

T : length of estimation period, which is from t1 until t2

- *Market Model*

Based on *Market Model*, calculating expected return is done with two steps, they are:

(1) Formulating expected model by using realized data during estimation period. This expected model can be formulated by

using regression technique which is the OLS (Ordinary Least Square). It is formulated as follows.

$$R_{i,j} = \alpha_i + \beta_i \cdot R_{M,j} + e_{i,j}$$

Where:

$R_{i,j}$: realized return of the i-security at j-estimation period

α_i : intercept for the i-security

β_i : slope coefficient which is the beta for the i-security

$R_{M,j}$: market index return at the j-estimation period formulated as $R_{Mj} = (IHGS_j - IHGS_{j-1}) / IHGS_{j-1}$

Where IHSG refer to Indonesian Composite Index (Indeks Harga Saham Gabungan) if the research uses IHSG as the market index.

$e_{i,j}$: residual value for the i-security at the j-estimation period

(2) Using the expected model to estimate expected return for the window period. It is formulated as follows.

$$E(R_{i,t}) = \alpha_i + \beta_i \cdot R_{M,t}$$

Where:

$E(R_{i,t})$: expected return of the i-security at t-estimation period

α_i : intercept for the i-security

β_i : slope coefficient which is the beta of the i-security

$R_{M,t}$: market return at t-estimation period

- *Market-Adjusted Model*

Market-Adjusted Model states that the best estimator to estimate return of a security is the current market index return. By using this model,

the estimation period is not used because the estimated return of the security is equal to the market index return.

For example, at the announcement date, the market index return is 18%. With the *market-adjusted model*, all the expected return of the security in the same day equals to the market index return which is 18%. If the return of the security is 35%, then the *abnormal return* is 17% (35%-18%). (Jogiyanto, 2003:445)

2.5. Previous Research

There have been several researches done due to the effect of IFRS adoption. The research done by Soderstorm and Sun (2007) examined the effect of IFRS mandatory adoption towards all companies listed in European Union. This research came up with result that cross-country differences in accounting quality remain following IFRS adoption because accounting quality is a function of the firm's overall institutional setting. Platikanova and Nobes (2006) examined whether IFRS adoption increases value-relevance of corporate disclosure using traders' response in financial markets of 15 European Union countries. This research came up with result that firms with higher country score for earnings management have a lower information asymmetry component. Research done by Daske et al. (2011) examined the economic consequences of mandatory IFRS reporting around the world. They analyze the effects on market liquidity and cost of capital. This research came up with result that on average market liquidity increases around the time of the introduction of IFRS.

Dan Amiran (2012) examined the association between IFRS adoption and foreign investment decisions. This research came up with result that foreign equity portfolio investment increase in countries that adopt IFRS. Research done by Naranjo et al. (2013) examined the influence of IFRS adoption towards financial decisions around the world. This research came up with result that firms are more likely to raise external financing. The research done by Landsman et al. (2011) examined whether the information content of earnings announcement-abnormal return volatility and abnormal trading volume-increases in countries that mandatorily adopt IFRS. This research came up with result that information content increased in 16 countries that mandated adoption of IFRS, although the effect of mandatory adoption depends on the strength of the legal enforcement of each country.

Research done by Karol Marek Klimczak (2011) examined the effects of mandatory IFRS adoption towards the abnormal return and the value relevance of earnings in Poland. This research came up with result that annual report publication does not produce unexpected information either before or after IFRS adoption. Research done by Chua et al. (2012) examined the effect of mandatory IFRS adoption towards accounting quality in Australia using earnings management, timely loss recognition, and value relevance as the measurements. This research came up with result that mandatory adoption of IFRS had resulted in better accounting quality than the Australian GAAP. Research done by Daske and Gebhardt (2006) examined whether IFRS

adoption in Austria, Germany, and Switzerland has led to higher quality financial reporting measured through the disclosure quality.

2.6. Hypothesis Development

One of the objectives of IASB is to develop a single set of high quality, understandable, enforceable, and globally accepted financial reporting standards based upon clear principles that requires high quality, transparent, and comparable information in financial statements and other financial reporting to help investors and other participants in the world's capital market to make economic decision (Deloitte, 2014). High quality means that financial reports will have to have the characteristics of relevance, faithful presentation, comparability, verifiability, timeliness, and understandability (SFAC No.8: Chapter 3). Thus, with the mandatory adoption of IFRS, it is expected that the quality of financial reporting will be increased so that any financial reports will fulfill the qualitative criteria.

The idea of this research is if the IFRS adoption in Indonesia increases the quality of financial reporting, the market will react positively towards the earnings announcement because increase in financial report quality means that information asymmetry decrease, which means that financial information transparency increase. When the financial information transparency increases, the investment climate will be supported because that means that investing climate in Indonesia is comparable to global investment climate. Then, whenever there are changes in the demand of capital market, the return given to investors will also change, where in this research the

average abnormal return and cumulative abnormal return is used as the measurement of the market reaction.

The idea of arguing that increase in financial reporting quality means that the information asymmetry decrease is supported by the research of Platikanova and Nobes (2006) who was examining the effect of IFRS adoption in Europe and found that firms with higher earnings management have a lower information asymmetry component. This argument is also supported by research done by Naranjo et al. (2013) resulted that at the post-IFRS period, firms are more likely to raise external financing and firms increase their use of equity capital if they experience decrease in information asymmetry.

Research done by Barth et al. (1999) found that there was a positive market reaction towards convergence in Europe. Investors reacted positively by purchasing firms' stock, that triggered increase of the stock price and caused a positive abnormal return (Thoradewa, 2012). However, research by Ball et al. (2003) found that the IFRS adoption in firms in East Asia did not bring any changes in the financial reporting quality. This happen because some investors believe that the cost to implement IFRS is greater than the benefit achieved, thus investors react negatively to the market by selling the shares they own and caused a decrease in stock price of the firms, and cause a negative abnormal return. Based on these idea and previous research, hypothesis can be formulated as follows:

H_a : There is significant difference of the market reaction to the earnings announcement measured by abnormal return before and after IFRS adoption.

