CHAPTER I

INTRODUCTION

1.1. Research Background

Stakeholders of a company require financial information regarding the company's financial performance that is useful in making decisions. Stakeholders include current and potential investors, lenders, and creditors. These parties make different decisions for the company depending on the company's financial performance presented by managers. Current investors face decisions that will represent the interests of the company as a whole. These decisions are proposed by managers. This is an illustration of the agency relationship in an organization between principals (the owners or current investors) and agents (the managers) in which conflicts arise due to information asymmetry and opportunistic behaviors. Managers must inform owners about the company's financial performance and the value of business investment opportunities in the form of useful financial information for decision-making.

The usefulness of financial information is determined by its qualitative characteristics: relevance, faithful representation, comparability, verifiability, timeliness and understandability. If financial information is to be fundamentally useful, it must be relevant and faithfully represent what it is meant to represent (i.e., company financial performance). Relevant financial information is capable of making a difference in decision-making. A perfectly faithful representation of financial information is complete, neutral, and free from error. Perfect representation of a company financial performance is improbable but efforts are being made to maximize these qualities. Researches on earnings quality provide evidence on the usefulness of financial information, specifically reported earnings.

According to Dechow et al. (2010), reported earnings cannot fully reflect a company's financial performance because of inherent constraints such as: 1) the lack of capability of the accounting system to produce a single reported earnings number that can provide a complete representation of company financial performance, 2) variation in companies' characteristics which inherently determine measured financial performance, and 3) the implementation of the accounting system by management which involves estimations and judgment. Research in earnings quality has made significant progress in assessing implementation issues or issues related with earnings management. Thus, most proxies or measures of earnings quality founded by previous research are measures of earnings management as well. In addition, most researchers have attempted to defy the previously stated problems by using multiple measures to capture different aspects of earnings quality and incorporate other variables to control for differences in the companies' characteristics. Furthermore, previous research in earnings quality provide evidences on several determinants of earnings quality including company characteristics, financial reporting practices, governance and controls, auditors, management incentives, and other external factors such as political processes and tax regulations.

A stream of researches in earnings quality provides evidence on various measures or proxies for the variable. This collection of measures is due to the belief that each measure captures a different perspective of earnings quality. Francis et al. (2004) 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. According to Dechow et al. (2010), previous researches have also utilize external indicators of earnings misstatements such as internal control deficiencies to measure the quality of earnings. In addition, their review indicates that the most common measure of earnings quality in research is abnormal accruals, which has become an accepted methodology to capture management discretion.

The International Accounting Standards Board (IASB) is the pioneer of regulating the standardization and harmonization of international accounting standards in over 100 countries. The practice of reporting under a set of globally accepted standards will likely reduce differences between financial statements and thus enhancing comparability, making it easier for users to analyze individual statements relative to others. The IASB is responsible for the regulation of two sets of accounting standards, International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs), the latter being the newer set of standards issued under the IASB. These two sets along with their interpretations will be generally referred to as IFRS or international accounting standards by the researcher.

In 1994, the Indonesian Institute of Accountants (IAI) decided to use international accounting standards as the basis for developing Indonesian Financial Accounting Standards (SAK) while maintaining several references to

U.S. Generally Accepted Accounting Standards (US GAAP) to harmonize local standards with globally accepted accounting standards. 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 SAK. However, until 2007, Indonesia has only developed 28 IFRS-based PSAKs from a total of 57 standards (Deloitte, 2007). On 15 November 2008, the G-20 international forum was held in Washington, D. C. The forum addressed and promotes the use of a single set of high-quality globally accepted accounting standards. On 8 December 2008, Indonesia, as a member of the G-20, made a public commitment to support IFRS (IFRS Foundation, 2014). Consequently, SAK effective as of 1 January 2012 is harmonized with IFRS effective as of 1 January 2009.

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). Several researches provide evidence on the impacts of IFRS convergence on the quality of reported earnings. Barth et al. (2008) provide earlier evidence on the impacts of reporting on the basis of IAS. Evidence suggest the application of IAS is associated with higher earnings quality indicated by less earnings smoothness, less small positive earnings, more timely loss recognition, and more value relevance. This comparison study does not provide direct evidence for IFRS convergence cases. Liu et al. (2011) and Jaweher and Mounira (2014) examine IFRS convergence cases and provide evidence indicating convergence is associated with less earnings smoothness, more timely loss recognition, and less small positive earnings as well. However, Jaweher and Mounira (2014) conclude that convergence with IFRS does not necessarily lead to higher quality of earnings from the perspective of the quality of accruals, value relevance of earnings, and conservative earnings.

Research in Indonesia that attempt to study the impacts of the IFRS convergence, completed as of 2012, on earnings quality is relatively small in number. Most researches study the impacts of the phased implementation of IFRS convergence effective as of 2011. These studies generally provide evidence which indicate no improvements in the measures of earnings quality utilized. For example, Bangun (2014) provides evidence that there is difference in discretionary accruals after IFRS convergence. However, descriptive statistics indicate higher amounts of discretionary accruals after convergence (i.e., lower earnings quality). Nata and Suranta (2014) suggest convergence does not generally impact discretionary accruals. Claudya (2014) utilizes the measure of earnings smoothness and results suggest convergence does not generally improve the quality of earnings. Sianipar and Marsono (2013) provide a one-year evidence on the effect of the full implementation of IFRS convergence. Results suggest that convergence does not generally affect value relevance, timely loss recognition, and discretionary accruals.

This research will examine the full implementation of IFRS convergence effective as of 1 January 2012 on the quality of earnings. Earnings quality will be measured by discretionary accruals and earnings smoothness to capture the different perspectives of earnings quality based on accounting measures. In addition, the research will provide a two-year evidence on the full implementation of IFRS convergence. This research differs from previous studies in an attempt to provide new evidence on the impacts of IFRS convergence in an emerging country based on these approaches.

1.2. Problem Statement

The convergence with IFRS should increase comparability of financial statements among the reporting entities that participate. Further, these standards are presumed to be high quality. High quality accounting standards should be more useful for decision makers. Decision makers can utilize many evaluation techniques to understand different attributes of earnings quality, including discretionary accruals and earnings smoothness. Thus, the following problems are investigated in this research:

1. Is there a difference in discretionary accruals from the full implementation of IFRS convergence effective as of 2012 for listed manufacturing companies on IDX?
2. Is there a difference in earnings smoothness from the full implementation of IFRS convergence effective as of 2012 for listed manufacturing companies on IDX?

1.3. Research Objectives

The objective of this research is to analyze and give empirical evidence about any differences in the measures of earnings quality between before and after the full implementation of IFRS-based PSAK for listed manufacturing companies on IDX.

1.4. Contribution of the Research

This research gives beneficial contribution to each of the following parties:

1. Theoretical development.

   The results of this research are expected to give researchers a future reference to understand studies of IFRS convergence and earnings quality, especially in an emerging country such as Indonesia.

2. Practitioners.

   The result of this research is expected to give new understanding to organizations and parties that are involved in the regulation of IFRS convergence or influenced by it.

1.5. Data Analysis

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

1. Gather the list of manufacturing companies listed on IDX in 2013.
2. Elect companies based on the sample criteria established.
3. Gather all required financial data for the measures of earnings quality.

4. Calculate discretionary accruals using the Jones (1991) model modified by Dechow et al. (1995).
5. Calculate earnings smoothness using earnings variability (Leuz et al., 2003).
6. Calculate the average value of earnings quality for each measure that will be representative of the pre-IFRS and post-IFRS data population.
7. Conduct a normality test.
8. Conduct hypothesis testing using a paired difference test.
9. Interpret and analyze the results.

1.6. Systematic Content

CHAPTER I : INTRODUCTION

This chapter describes the background of the research, problem statement 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 : THEORETICAL 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, measuring earnings quality, and analyzing the data. It includes the definition of earnings quality and measurement of its variables using previously proposed models.

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.