CHAPTER II

THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1. Theoretical Background

2.1.1. International Financial Reporting Standards

The International Accounting Standards Committee (IASC) was established in 1973 through an agreement made by several national accountancy bodies and became the structure for setting IASs. The Standard Interpretations Committee (SIC) was later formed in 1997 with the mission to develop interpretations of IASs (SIC-Interpretations). The IASC and SIC underwent further restructuring after the need to bring convergence between national and high-quality global accounting standards and practices was reconsidered in order to perform the role of the structure effectively. A new structure was introduced in 2001 and the IASB and IFRS Interpretations Committee (IFRIC) were formed to replace the previously mentioned bodies.

The objective of the IASB is to develop a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. It is overseen by a diverse body of trustees who are publicly accountable to a Monitoring Board of public capital market authorities and supported by an external IFRS Advisory Council and an Accounting Standards Advisory Forum of national standard-setters. The IFRIC also offers support by providing guidance on matters not discussed in the

accounting standards. The IASC and IASB have issued two sets of international accounting standards, the IASs and the IFRSs, respectively.

Having jurisdiction in over 100 countries and with an aim to develop globally accepted financial reporting standards, the IASB is the pioneer of standardization and harmonization of accounting standards. It is important to distinguish the definition between standardization and harmonization to understand research in IFRS convergence. Standardization of accounting standards involves the full-adoption of uniform standards in all countries that participate, while harmonization is a reconciliation of different points of view and allows different requirements in countries provided that there is no logical conflict (Canibano and Mora, 2000). Likewise, Van der Tas (1988) states harmonization is a tuning of two or more objects and it would be useful for users who are confronted with financial reports if the financial statements were more in harmony. It is presumed to be useful because the practice of reporting under a set of global accepted standards will likely reduce differences between financial statements enhancing comparability and thus making it easier for users to analyze individual statements relative to others. Canibano and Mora (2000) define an increase in comparability as a situation in which more companies which face similar circumstances apply the same method to an accounting event or give additional information in a way so the financial reports can be made more comparable.

2.1.2. Development of Accounting Standards in Indonesia

The development of SAK began in 1957 when IAI was formed. The first milestone in the history of the development of SAK occurred in 1973 with the activation of the capital market. In the same year, the IAI performed the first codification of Indonesian accounting principles and standards in a book titled "Prinsip Akuntansi Indonesia (PAI)." The second milestone occurred in 1984 when the PAI Committee made fundamental revisions to PAI 1973 and codified them in PAI 1984.

In 1994, revisions were made to PAI 1984 and codified in "Standar Akuntansi Keuangan (SAK) per 1 Oktober 1994." Since then, the IAI has decided to use international accounting standards instead of US GAAP as the basis for developing SAK, with maintaining several references to US GAAP, to harmonize local accounting standards with high-quality globally accepted accounting standards. Consequently, SAK has been continuously developed and revised through several improvements and additions to fully harmonize and converge with IFRS. The latest revisions to SAK were made in 2014. These standards and interpretations will be effective as of 2015.

The current independent standard-setting body in Indonesia is the Financial Accounting Standards Board (DSAK) under the IAI. Under Indonesian law, all companies must comply with SAK issued by the DSAK-IAI as these standards are recognized by the Government of the Republic of Indonesia.[1]

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[1] SAK consists of Statement of Financial Accounting Standards (PSAK), Interpretation of Financial Accounting Standards (ISAK), Revocation Statement of Financial Accounting Standards (PPSAK Umum), Statement of Financial Accounting Standards for Syariah Entities (PSAK Syariah), and Financial Accounting Standards for Entities without Public Accountability (SAK ETAP). This research will mainly focus on differences in PSAK between before and after the full implementation of IFRS convergence.

2.1.3. IFRS Convergence in Indonesia

The IASB issued its first standard, IFRS 1 First-time Adoption of International Financial Reporting Standards, under the new IFRS Foundation in 2003. This standard is not to be adopted by the participants because it will have been considered in the transitional provisions of individual standards and interpretations. According to the IFRS Foundation, Indonesia's current commitment to IFRS is to support it as the globally accepted accounting standard and to continue with the IFRS convergence process, further minimizing the differences between SAK and IFRS (IFRS Foundation, 2014).

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. Until 2007, Indonesia had only developed 28 IFRS-based PSAKs from a total of 57 (Deloitte, 2007). Full convergence to IFRS was prioritized after the G-20 forum was held in Washington, D.C. on 15 November 2008. Indonesia has also made the public commitment to support IFRS on 8 December 2008 and as a result, SAK effective as of 1 January 2012 is substantially harmonized with IFRS effective as of 1 January 2009.

The G-20 international forum was originally founded in 1999 with the aim of studying, reviewing, and promoting high-level discussion of policy issues concerning the enhancement of global financial stability. In the Leaders'

Declaration of the 2008 G-20 Washington Summit on Financial Markets and the World Economy, the Leaders of the Group of Twenty made a commitment to implement policies consistent with the following principles for the reformation of the world's financial systems:

a. Strengthening Transparency and Accountability.

b. Enhancing Sound Regulation.

c. Promoting Integrity in Financial Markets.

d. Reinforcing International Cooperation.

e. Reforming International Financial Institutions.

The Leaders of the Group of Twenty met again in London on 2 April 2009 and issued The Global Plan for Recovery and Reform which includes a set of goals to be achieved by the participants. One of the goals for the G-20 is Strengthening Financial Supervision and Regulation. For this goal, the Leaders issued Declaration on Strengthening the Financial System that states several accounting issues to be addressed and promotes the use of a single set of high-quality globally accepted accounting standards amongst its participants:

a. reduce the complexity of accounting standards for financial instruments;

b. strengthen the accounting recognition of loan-loss provisions by incorporating a broader range of credit information;

c. improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty;

d. achieve clarity and consistency in the application of valuation standards internationally, working with supervisors;

e. make significant progress towards a single set of high quality global accounting standards; and,

f. within the framework of the independent accounting standard setting process, improve involvement of stakeholders, including prudential regulators and emerging markets, through the IASB's constitutional review.

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.

Source: Lestari (2011)

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. Therefore, SAK effective as of 1 January 2015 is substantially harmonized with IFRS effective as of 1 January 2014.

2.1.4. IFRS Convergence

The scope of this research will focus on the full implementation of IFRS convergence that is effective as of 2012. It is important to note that some of the SAK from this convergence process has already been issued and effective as of 2011. However, the goal of this research is not to examine the phased implementation of new IFRS-based standards, but the complete effect of the convergence process including the standards that are effective as of 2012. Further analysis of these standards relating to the manufacturing industry in Indonesia provides evidence on its most major implications in corporate financial reporting. Several examples are generalized in the following tables.[2]

Table 2.2

Accounting Standards for Employee Benefits

No	Criteria	Explanation
1	Scope	PSAK 24 (Revised 2010), adopted from IAS 19 (2009), updates PSAK 24 (Revised 2004) and introduces guidance for defined benefit plans that share risks between various entities under common control (e.g., a parent and its subsidiaries). A reporting entity that participates in a group pension plan should obtain information about the plan as a whole, measured and allocated among participating entities in accordance with PSAK 24.
2	Recognition	Full recognition of actuarial gains (losses) from defined benefit plans can now immediately be outside profit or loss, in Other Comprehensive Income (OCI). This latest approach adds to the corridor approach (amortization through profit or loss) and the full recognition approach immediately in profit or loss. If a reporting entity chooses to recognize actuarial gains (losses) in OCI, all existing unrealized actuarial gains (losses) are immediately charged to OCI in the year PSAK 24 is adopted.
3	Disclosure	All entities reporting under this standard will be required to disclose more information, especially for defined benefit

[2] Further analysis of the differences was conducted on new and revised PSAKs effective as of 2011 and 2012. This analysis is also much reinforced by the findings provided by PwC Indonesia online publications, including A Practical Guide to New PSAKs for 2012 and Summary of New Accounting Standards 2011.

No	Criteria	Explanation
		pension plans. Several examples are the disclosures of: a. the opening and closing balances of the fair value of plan assets, including adjustments; b. the percentage or amount of each major category of plan assets respective to the individual fair values and total; c. a narrative description of the basis used to determine the overall expected rate of return on assets; d. the amounts included in other comprehensive income; and e. the amounts for the current annual period and the previous four annual periods of the present value of the defined benefit obligation, the fair value of the plan assets, and experience adjustments arising on plan liabilities and plan assets.

Reporting entities that have defined benefit pension plans will likely experience the most impact from the revised PSAK 24. The standard shed light on the procedures for allocating costs between participating entities for group pension plans. The standard also introduces an alternative accounting choice for the recognition of actuarial gains or losses from defined benefit plans in OCI. Reporting entities that elect to practice this accounting method for recognition can shift losses from net earnings to special items. Furthermore, extensive requirements for disclosures encourage managers to clarify accounting practices that describe reported financial numbers.

Table 2.3

Accounting Standards for Leases

No	Criteria	Explanation
1	Classification	PSAK 30 (Revised 2011), adopted from IAS 17 (2010), updates PSAK 30 (Revised 2007) and introduces new classification rules for leases involving land: a. When a lease includes both land and building, classification as finance or operating lease is performed separately on each asset in accordance with the principles provided in PSAK 30.

No	Criteria	Explanation
		b. When classifying a lease of land as finance or operating lease, the general assumption is that land has an indefinite useful life. Before revision, accounting standards required a lease of land with an indefinite useful life to be classified as an operating lease, unless there is an exchange of title at the end of the lease term. c. Entities reporting under PSAK 30 should reconsider the classification of land and building elements of unexpired leases at the date PSAK 30 is adopted on the basis of information existing during the inception of those leases.
2	Recognition	When a lease includes a land and a building element, the measured minimum lease payments is allocated between the land and building elements in proportion to the relative fair values of their respective components of the lease agreement at inception date.

The revised PSAK 30 requires companies to reclassify all leases involving land in accordance with the principles provided in PSAK 30. Prior to revision, a lease of land can only be classified as a finance lease if title passes at the end of the lease term. However, the new standard revised this rule and introduced more possibilities for classifying a lease of land as a finance lease. In such cases, the reclassification as a finance lease introduces an asset and liability component on the balance sheet of the lessee. This reclassification will likely reduce the total periodic expense recognize from the lease because land is not depreciated since in most cases it is assumed to have an indefinite useful life. This reclassification introduces a receivable asset on the balance sheet of the lessor and will reduce the total periodic revenue recognize, since cash received from the lease is treated as a payment for the receivable and not a revenue recognition.

In addition, the total value of the land and building elements are allocated on a pro-rata basis of the relative fair values of each asset, thus better reflecting their respective exchange values at arm's length transaction.

Table 2.4

Accounting Standards for Share-based Payment

No	Criteria	Explanation
1	Scope	PSAK 53 (Revised 2010), adopted from IFRS 2 (2009), updates PSAK 53 (Revised 1998) and requires reporting entities to present the impacts of share-based payments on the income statement and balance sheet. PSAK 53 (Revised 1998) included share-based payments involving equity-settled awards in its scope. The revised standard scopes out to additional groups of share-based payments including: a. transactions involving cash-settled awards, b. transactions giving the option for selecting between equity-settled or cash-settled awards, and c. transactions of group share-based payment (e.g., transaction between a parent and subsidiaries).
2	Recognition	The difference in the fair values of share-based payment liabilities at the end of each period is recognized in the income statement. Modification of the liability that results in the changes in fair value of equity instruments granted should be recognized. Cancellation of the liability is an acceleration of vesting that should be recognized.
3	Measurement	Reporting entities are required to measure the impacts of share-based payments using the new basis of fair value. a. Share-based payment transactions involving non-employees are usually measured at the fair value of the goods or services received. b. Share-based payment transactions involving employees are usually measured at the fair value of the equity instruments granted. c. Liabilities arising from share-based payment transactions are restated at fair value at the end of each period. In addition, PSAK 53 considers different vesting and non-vesting conditions in share-based payment transactions.
4	Disclosure	The revised standard requires extensive disclosures regarding share-based payment transactions. Several examples include: a. nature and the description of key terms of the arrangement, b. reconciliation of the number and the weighted average

No	Criteria	Explanation
		exercise prices of share options, and c. the methods and assumptions used to determine the fair value.

The revised standard introduces significant changes to the scope and accounting approach for share-based payments. In general, reporting entities will have to understand how every situation of a share-based payment transaction should be accounted in accordance with the principles in PSAK 53. It is highly likely there will be more expense recognition due to the introduction of a significant amount of share-based payment groups that has to be accounted for, including awards settled by entities within a group. Furthermore, the general method of measurement for recognition is based on fair value. The estimation of fair value is dependent on several factors, including the (estimated) stock market price, vesting conditions, and option pricing models. Dependency on fair value will result in a reporting number better reflecting the exchange values at arm's length transaction. The revised PSAK 53 also introduces extensive disclosure requirements.

In addition to the previously mentioned changes regarding the issuance of extensive disclosure requirements, PSAK 60 Financial Instruments: Disclosures merges and extends several existing disclosure requirements and introduces some significant and challenging new disclosures. Some of the required disclosures in PSAK 60 replace the requirements previously found in PSAK 50 Financial Instruments: Presentation such as the requirements for disclosure of qualitative information about credit risk, liquidity risk, and market risk. Furthermore, PSAK

60 adds a new requirement to disclose summary of quantitative data on risk exposure at reporting date. Also, PSAK 60 requires extensive disclosures of information pertaining to the fair values of each class of financial asset and financial liability. A few examples have already been mentioned.

2.1.5. Agency Theory and Information Asymmetry

An agency relationship is a contract under which one or more persons (the principal(s)) engage another group of people (the agent) to perform services on their behalf which involves handing over some decision making authority to the agent (Jensen and Meckling, 1976). If both parties under contract favor maximizing personal gains, it is highly likely that the agent will not always act in agreement with the interests of the principal. A disagreement can lead to problems (agency conflicts) between the principal and agent which can harm both parties' interests. However, the principal can limit divergences from his interest caused by the dysfunctional behavior of the agent through monitoring and other control activities.

In the corporate environment, agency conflicts arise primarily due to information asymmetry and, consequently, the opportunistic behavior of self-interested managers. Healy and Palepu (2001) define information asymmetry as an "information problem" when managers have better information than investors about the value of business investment opportunities and incentives to overstate their value. Once investors have made the decision to spend, managers have the chance to opportunistically expend the costs. The demand for high-quality

financial reporting and disclosure primarily arises due to information asymmetry and agency conflicts between managers and investors (Healy and Palepu, 2001).

2.1.6. Earnings Quality and Earnings Management

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."

The first feature of the definition for earnings quality is related to a fundamental qualitative characteristic of useful financial information, faithful representation. The IFRS Conceptual Framework for Financial Reporting defines a perfectly faithful representation of financial reports is complete, neutral, and free from error. A complete representation includes all information necessary for a user to understand the phenomenon, the company's financial performance in this case, being represented. A neutral representation is without bias in the selection or presentation of financial information and thus is not manipulated to increase the probability that financial information will be received favorably by users. A representation free from error does not present any omitted information in the description of the company's financial performance, and the process used to produce the reported information has been selected and applied with no errors. Perfect faithful representation is unlikely achievable but efforts are being made by standard setters to maximize these qualities.

The second feature of the definition for earnings quality is related to another fundamental qualitative characteristic of useful financial information, relevance. The IFRS Conceptual Framework for Financial Reporting define relevant financial information as information capable of making a difference in the decision made by users (e.g., current and potential investors, lenders, and creditors) by way of having predictive value, confirmatory value or both. Financial information has predictive value if it can be used as an input to models employed by users to predict future outcomes for their own predictions (i.e., decisions to invest or lend). Financial information has confirmatory value if it can be used to confirm or correct previous evaluations. In most cases, information that has predictive value also has confirmatory value. In other words, information that has confirmatory value will likely have predictive value. Information is material if removing it or misstating it could influence decisions that users make. Hence, materiality is an aspect of relevance.

In the context of earnings quality research, the examined financial information is reported earnings. Dechow et al. (2010) define reported earnings as obtainable earnings acquired from the accounting system's ability to convert unobservable company financial performance. Reported earnings cannot fully reflect the unobservable aspect of a company's financial performance because of the presence of inherent constraints when an accounting system measures performance. Dechow et al. (2010) present three explanations for why an accounting system would not perfectly convert unobservable company financial performance:

a. multiple decision models,

An accounting system that produces a single reported earnings number cannot produce a representation of unobservable financial performance that is equally relevant or useful in all decision models. Research in earnings quality has shown evidence that each decision model captures a different aspect of earnings quality. Thus, multiple decision models are used to fulfill different requirements deemed necessary by users, with the intention of making different decisions, to illustrate earnings quality. According to Dechow et al. (2010), standard setters make "trade-offs" in setting standards across anticipated users' needs, and as a result no individual acquires a representation of company performance that is perfectly relevant for his or her decision. Thus, this constraint is related with the accounting system's lack of ability to perfectly capture unobservable financial performance in a single reported earnings number.

b. variation in unobservable financial performance, and

Companies choose amongst a limited set of pre-determined measurement principles (e.g., accounting standards) to measure unobservable financial performance. However, no single standard will perfectly measure unobservable financial performance for companies (e.g., measures of Cost of Goods Sold, which represent the reportable measure of a company's unobservable inventory performance). Furthermore, companies with different characteristics will not produce equally good measures of relevant performance.

c. implementation.

An accounting system that measures unobservable financial performance involves estimations and judgment, and consequently has the potential for unintentional errors and intentional bias, i.e., earnings management.

As stated by Dechow et al. (2010), research in earnings quality has made significant progress in implementation issues or issues related with earnings management. Thus, most of the evidence provided in the research of earnings quality uses a proxy or measure that is viewed as an indication of earnings management. Healy and Wahlen (1999) define earnings management as a situation in which managers choose reporting methods and estimates that do not accurately reflect their firms' underlying economics for the manager's benefit of receiving advantageous resource allocation and decision making from stakeholders. Earnings management is assumed to reduce earnings quality because it reduces the decision usefulness of reported earnings.

A constructed decision model that attempts to measure reported earnings, which capture a company's financial performance, is inherently influenced by determinants. A review of the studies in earnings quality literature provides evidence on several determinants of earnings quality. Dechow et al. (2010) distinguish these determinants in six categories:

a. company characteristics,

Previous studies have provide evidence that weak company performance, higher debt levels, high reported growth, and smaller firm size encourage engagement in accounting tactics to improve earnings and lower earnings

quality. The findings of Doyle et al. (2007) indicate that some portion of earnings quality is associated with innate drivers of poor quality such as the measure of firm size or sales volatility.

b. financial reporting practices,

Researchers have used several features of financial reporting practices to predict earnings quality such as accounting methods including principles, estimates associated with accounting principles, estimates outside accounting principles, financial statement classification, interim reporting, and principles based versus rules based methods. McVay (2006) examines the classification of items of the income statement and found evidence consistent with managers opportunistically shifting expenses from core expenses (cost of goods sold and selling, general, and administrative expenses) to special items. The vertical shift of expenses overstates "core" earnings or net earnings. Managers use this tool to meet analyst forecast earnings expectations since special items are usually excluded from analyst definitions of earnings.

c. governance and controls,

Jensen and Meckling (1976) state that it is generally impossible for the principle or the agent at zero monitoring and controlling costs to ensure that the agent will make optimal decisions based on the principal's viewpoint. Furthermore, studies have shown monitoring and controlling mechanisms including characteristics of the Board of Directors (BOD), internal control procedures, managerial share ownership, managerial

compensation, and managerial change are all determinants of earnings quality. To illustrate, Doyle et al. (2007) found that weaknesses in internal control are generally associated with poorly estimated accruals that are not realized as cash flows.

d. auditors,

Jensen and Meckling (1976) include auditing as one of many methods used to alter the opportunity the manager has for capturing non-financial benefits in the agency relationship. Caramanis and Lennox (2008) test the effect of audit effort measured by hours worked by auditors on earnings management measured by discretionary accruals, a specific decision model to measure earnings quality, and concluded that low audit effort increases the extent to which managers are able to report aggressively high earnings.

e. equity market incentives, and

Many studies have provided evidence that when companies raise capital (e.g., initial public offering) or try to beat earnings target, incentives arise to engage in accounting choices to improve earnings.

f. external factors.

Considerable evidence from previous studies suggests that external factors such as capital requirements, political processes, regulatory nature and enforcement, and tax and non-tax regulation are associated with accounting choices and thus are determinants of earnings quality.

2.1.7. Measures of Earnings Quality

A stream of studies in earnings quality indicates many measures or proxies of the variable. This diversity is due to the fact that each measure captures a different aspect of earnings quality and is chosen depending on the specific decision model. As a result, not any one measure is superior for all decision models. For this reason, these measures are sometimes referred to as attributes of earnings quality 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.

In a broader aspect, 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 table summarizes the findings on the measures of earnings quality.

Table 2.5

Measures of Earnings Quality

Empirical proxy	Category	Theory
Persistence	Accounting-based	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

Empirical proxy	Category	Theory
		measure is often more useful for long term evaluation.
Predictability	Accounting-based	Predictability is a measure of earnings quality based on the ability of earnings to predict itself.
Magnitude of accruals	Accounting-based	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.
Accruals quality	Accounting-based	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.
Abnormal accruals	Accounting-based	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.
Smoothness	Accounting-based	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.
Value relevance	Market-based	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.
Timeliness	Market-based	Timeliness is an attribute of earnings quality

Empirical proxy	Category	Theory
	based	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.
Conservatism	Market-based	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 (measured as negative stock returns) and gains (measured as positive stock returns).
ERCs	Market-based	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.
Benchmarks (target beating)	Accounting-based	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 small number of firms with small losses and a large number of firms with small profits.
External indicators of earnings misstatements	N/A	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. The models of abnormal accruals have become an accepted methodology in accounting to capture discretion. Accordingly, the researcher will use the proxy of abnormal accruals as an indicator for the quality of earnings.

In attempting to measure abnormal accruals, there must be an initial method of measuring for total accruals, which has been most commonly done by separating revenue recognition in cash flows from earnings. Once achieved, the next procedure is to separate total accruals into two hypothesized components: "abnormal" and "normal" or discretionary and nondiscretionary. Nondiscretionary accruals are assumed to capture accounting adjustments, made by an accounting system, which attempt to reflect company financial performance. Discretionary accruals are the residuals from total accruals which are assumed to capture estimation errors or discretion of management in the accounting process for accruals due to an imperfect measurement system (Dechow et al., 2010). Therefore, measures of abnormal accruals attempt to indirectly capture problems with the accounting measurement system which reduce earnings quality.

The general approach in separating the two components is to model the accrual process. In modeling the accrual process, if the "normal" component of accruals is measured properly, the abnormal component will represent earnings that are not driven by company financial performance. According to Dechow et al. (2010), models widely used in accounting research for measuring normal levels of accruals using a balance sheet and income statement approach include the Jones (1991), modified Jones model (Dechow et al., 1995), and performance matched model (Kothari et al., 2005).

The Jones (1991) model defines that gross fixed assets and change in net sales revenues determine changes in nondiscretionary components of total accruals. Dechow et al. (1995) identify a problem with the Jones (1991) model

with the assumption of a condition in which earnings are managed through discretionary sales revenues. Consequently, the model is hypothesized to classify these types of accruals as normal when they are not. Dechow et al. (1995) modify the Jones (1991) model in an attempt to solve the problem by separating abnormal features resulting from growth in credit sales and the normal component of accruals. Dechow et al. (2010) state the modified Jones (1991) model still suffers from classifying accruals as abnormal when they are a representation of a company financial performance, even to greater degree than the Jones (1991) model. Kothari et al. (2005) attempt to solve the problem of correlations between performance and residuals by means of controlling for the normal levels of accruals conditional on company performance measured as return on assets. However, Dechow et al. (2010) state the model can lead to low power tests and should be applied only when performance is an issue. Based on these findings, the researcher is encouraged to use the modified Jones (1991) model for the measurement of abnormal accruals to avoid problems associated with the original Jones (1991) model and complexity of implementing the performance matched model.

The researcher will also use earnings smoothness as the other accounting-based proxy to capture a different aspect of earnings quality. It is important to understand the differences in what each measure tries to capture. The measure of abnormal accruals only captures estimation errors and management's opportunistic intent on current accruals. These accruals are not the result of the company's financial performance. Furthermore, when accruals are manipulated,

the reported earnings will be affected and will deviate from its true or intended value.

Eckel (1981) defines two types of income smoothing, natural smoothing and intentional smoothing. Natural smoothing implies that the income generating process naturally produces a smooth income stream. Intentional smoothing is conducted by management. There are two types of intentional smoothing, real smoothing and artificial smoothing. Real smoothing represents management actions to smooth earnings by undertaking control of underlying economic events. Artificial smoothing represents accounting manipulations made under the intention of management to smooth income. The measure of earnings smoothness uses information of reported earnings and thus will be affected by discretionary and non-discretionary accruals. Furthermore, according to Leuz et al. (2003), financial reporting choices can be used by managers to conceal changes in company's financial performance and smooth income. The measure proposed by Leuz et al. (2003) is a measure of earnings variability, a ratio of operating income standard deviation to operating cash flow standard deviation, which will also be implemented in this study.

2.2. Previous Research

One of the most prominent researches in international accounting standards is conducted by Barth et al. (2008) and provides earlier evidence on the implications of reporting on the basis of IAS. The study suggests higher earnings quality is associated with companies applying IAS indicated by measures of less

earnings smoothness, less small positive earnings, more timely loss recognition and more value relevance. Jaweher and Mounira (2014) also conducted a recent major cross-country study by examining a different setting in Australia and Europe with a different time frame from 2001 until 2010. The findings suggest IFRS convergence does not generally improve earnings quality, evident from the quality of accruals, value relevance, and conservative earnings. These findings are contradictory to the previous findings of Barth et al. (2008).

In China, local standards are substantially converged with international standards. Liu et al. (2011) conducted a study on the effects of IFRS-based accounting standards on earnings quality operationalized with earnings smoothness, timely loss recognition, and small positive earnings measures. Results of this measures show consistency with the evidence provided by Barth et al. (2008) and Jaweher and Mounira (2014) regarding the previously mentioned proxies. Indonesia offers a similar setting as China. Local standards are being continuously converged with international standards with no future plan of full adoption. It is important to gather previous research in Indonesia to understand the current evidence provided concerning this research.

Only a small number of researches has been conducted to examine the effects of IFRS convergence in Indonesia. Furthermore, 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 implementation of IFRS as of 2011. Bangun (2014) examines the impact of the

phased implementation on earnings quality using a paired sample t-test on discretionary accruals. Evidence indicates a significant difference in discretionary accruals between before and after 2011. In addition, descriptive statistics indicate that the mean data of discretionary accruals is actually higher during post-IFRS reporting years, and thus lower earnings quality. Under different data analysis methodologies, Nata and Suranta (2014) provide contradictory evidence. Nata and Suranta (2014) examine discretionary accruals, audit quality, and other control variables using a multiple regression analysis. Claudya (2014) examines a different pre-IFRS time frame of 2006 and 2007, before any IFRS were actually adopted into local standards. Claudya (2014) uses a different measure, earnings smoothness, for evaluating earnings management. Evidence suggests IFRS convergence does not generally improve earnings quality, albeit an improvement in the value relevance of earnings.

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 highlight that the time frame of this study is only two years. The following table generalizes previous research relating to this study.

Table 2.6

Previous Research

No	Research	Setting and Time Frame	Variables	Results
1	Barth et al. (2008)	Cross-country study.	Earnings quality is operationalized with	Earnings quality are higher for companies

No	Research	Setting and Time Frame	Variables	Results
		Time period: 1994 – 2003.	earnings management, timely loss recognition, and value relevance. Earnings management is measured by three measures of earnings smoothness and small positive earnings.	applying IAS indicated by less earnings smoothness, less small positive earnings, more timely loss recognition, and more value relevance.
2	Liu et al. (2011)	China. Pre-IFRS: 2005 – 2006. Post-IFRS: 2007 – 2008.	Earnings quality is operationalized with earnings management and value relevance. Earnings management is measured by three measures of earnings smoothness, timely loss recognition, and small positive earnings.	The quality of earnings, especially indicators of earnings management, significantly improved. Evidence reveals an increase in value relevance of reported earnings and decrease in earnings smoothness.
3	Jaweher and Mounira (2014)	Australia and Europe. Pre-IFRS: 2001 - 2004. Post-IFRS: 2005 - 2010.	Earnings quality is operationalized with earnings management and value relevance. Earnings management is measured by three measures of earnings smoothness, timely loss recognition, and small positive earnings.	Mandatory IFRS adoption improves the predictability of cash flows and future earnings, persistence, and timeliness. Results also suggest that target beating and smoothing practices are less. However, earnings are more value relevant and conservative and quality of accruals is better under local standards.
4	Claudya (2014)	Indonesian LQ45 companies. Pre-IFRS: 2006 – 2007. Post-IFRS: 2011 – 2012.	Earnings quality is operationalized with earnings smoothness and value relevance.	IFRS convergence improves value relevance of earnings. However, there is no difference in earnings smoothness between before and after IFRS

No	Research	Setting and Time Frame	Variables	Results
				convergence.
5	Bangun (2014)	Indonesian manufacturing companies. Pre-IFRS: 2009 - 2010. Post-IFRS: 2011 - 2012.	Earnings quality is operationalized with discretionary accruals.	There is a difference in earnings quality between before and after IFRS convergence.
6	Nata and Suranta (2014)	Indonesian manufacturing companies. Pre-IFRS: 2009 - 2010. Post-IFRS: 2011 - 2012.	Earnings quality is operationalized with discretionary accruals. The study also examines the influence of audit quality and other control variables.	Findings suggest that IFRS convergence does not improve earnings quality. Furthermore, involvement of a Big 4 audit firm actually increases earnings management.
7	Sianipar and Marsono (2013)	Indonesian manufacturing companies. Pre-IFRS: 2011. Post-IFRS: 2012.	Earnings quality is operationalized with discretionary accruals, value relevance, and timely loss recognition.	Findings do not provide evidence on the difference of value relevance, timely loss recognition, and earnings management measures between before and after IFRS convergence.

2.3. Hypothesis Development

2.3.1. IFRS Convergence and Discretionary Accruals

Although this paper uses the terms abnormal and discretionary interchangeably to refer to the whole amount of abnormal accruals, there is a difference between them. Abnormal accruals are accruals of reported earnings that cannot explain company financial performance. These accruals are either the result of the application of accounting rules or discretion asserted on (discretionary) accruals. Both reduce the decision usefulness of reported earnings.

The application of accounting rules can lead to accruals which are unable to reflect company financial performance because of estimation and professional judgment involved in the measurement and recognition of underlying transactions.

To illustrate, PSAK 30 (Revised 2007) generally required all leases of land to be classified as an operating lease unless title passes at the end of the lease term, even though the land has an indefinite useful life. However, the new PSAK 30 (Revised 2011) provides more conditions under which a lease of land can be classified as a finance lease (e.g., leases of land over 99 to 999 years). Hence, this new accounting rule should reflect company financial performance better for cases of land leases.

Discretion asserted on accruals also leads to accruals which are unable to reflect company financial performance. This aspect of abnormal accruals is not explained by the fault in the accounting system, rather by the lack of the ability of an imperfect accounting system to minimize management discretion. The role of new extensive disclosure requirements will try to shed light on the accounting procedures that produce the financial numbers. In other words, managers will have to explain the methods and choices made in presenting reported earnings (e.g., changes in fair values).

Although new standards suggest better accounting rules and a significant amount of new extensive disclosure requirements, it's easy to assume discretionary accruals will be less or significantly different after IFRS convergence. Previous researches on discretionary accruals generally indicate otherwise. The findings of Nata and Suranta (2014) provide evidence for the

phased implementation as of 2011 indicating no improvement between before and after convergence. Additionally, Sianipar and Marsono (2013) study of the full implementation provide evidence indicating no difference between before and after convergence. However, this amount of evidence is still insufficient. Hence, the researcher deduces the following hypothesis:

Ha$_1$: There is a difference in discretionary accruals between before and after the full implementation of IFRS convergence.

2.3.2. IFRS Convergence and Earnings Smoothness

The measure for earnings smoothness in this research is earnings variability. This measure also attempts to capture accrual quality (Francis et al. 2004). Earnings smoothness is assumed to be a desirable attribute of earnings quality because it attempts to capture opportunistic management planning to smooth fluctuations in past, current, and future income. As previously discussed, earnings can be smoothed through real and artificial ways. Measures of earnings smoothness attempt to capture artificial smoothing practices which are unrepresentative of the company's financial performance. Firstly, discretionary accruals lead to manipulated earnings or earnings that deviate from its true or intended value. Discretionary accruals can also be used to smooth income. Secondly, earnings can be managed by the application of accounting standards, and thus professional judgment play a role.

To illustrate, PSAK 24 (Revised 2010) introduces an alternative accounting choice for the recognition of actuarial gains or losses from defined benefit plans in OCI. Reporting entities that elect to practice this method of recognition can shift losses from net earnings to special items. Ultimately, this can be used among other income items' recognition to plan a smooth income. This is a financial reporting practice called classification shifting. McVay (2006) study provide evidence that managers opportunistically shift expenses from "core" expenses (cost of goods sold and selling, general, and administrative expenses) to special items to overstate "core" (net) earnings. This "shift" of income statement items will cause the value of net earnings to deviate from its intended value, and thus it will be unrepresentative of company financial performance.

The new set of accounting standards effective from the IFRS convergence widens the scope for many item recognitions including land leases as a finance lease (PSAK 30), additional share-based payment liabilities (PSAK 53), impairment of goodwill and other intangible assets with an indefinite useful life (PSAK 48), etc. A broader scope for profit and loss recognition through these items should likely lead to more fluctuating earnings. Claudya (2014) examines the effect of the phased implementation as of 2011 and provide evidence for an alternative hypothesis suggesting no difference in earnings smoothness between the sampled pre-IFRS and post-IFRS periods. However, the amount of evidence provided from a single research is still insufficient. Hence, the researcher deduces the following hypothesis:

Ha$_2$: There is a difference in earnings smoothness between before and after the full implementation of IFRS convergence.