

CHAPTER I

INTRODUCTION

1.1. Research Background

Financial reporting is one source of information that communicates the financial condition of the company's operating activities in a certain time to interested parties. According to SFAC No.8, there are two purposes of financial statements. First, provide useful information to investors, potential investors, creditors, and other users to make investment decisions, credit, and other similar decisions. Second, provide information about the current prospects cash to help investors and creditors in assessing cash flow prospects of company.

Information about the ability of companies in generating earnings can help investors and prospective investors to assess company's ability to generate cash flow in the future. Statement of cash flows was required to be reported in 1987 by SFAS No.95. In Indonesia, the requirement to report cash flows began in 1994 by SFAC No.2 (nowadays, SFAC No.8) which states that companies must prepare a cash flows statement and present it as the part of financial statements for each period.

Earnings is a component of financial statements of the company. Earnings has the following benefits such as, use to assess the management performances, help in estimate the ability of representative earnings in long term period and assess the risk of investment (Parawiyati, 2000). According to Dahler (2000),

there is a relation between earnings and future cash flows. Earnings has an ability to predict future operating cash flows and have a greater ability than cash flows if earnings were divided into some components of accruals. Earnings and cash flows are indicator to determine company's financial performance that increase or decrease over horizontal comparison. These changes impact on the financial policy of next period activity.

Accounting conservatism appears in order to improve financial reporting. This principle tend to suggest the company report lower earnings in order to deal with uncertain economic and business condition, assessed assets with the lowest value, and liabilities with the highest value. Financial Accounting Standards gives a freedom to company in choosing accounting methods used. Company chose the method of accounting in accordance with the conditions. In order to anticipate the unstable economic conditions, the company must be careful in presenting the financial statements

Conservatism can be defined as a tendency which is owned by an accountant which requires a higher level of verification to recognize earnings (good news in earnings) compared to acknowledge losses (bad news in earnings) (Basu, 1997). Traditionally, conservatism in accounting can be translated via the statement "does not anticipate profit, but anticipate all losses "(Bliss, 1924 in Watts, 2003a). Conservatism in accounting implies the existence of an asymmetrical verification requirement between profit and loss recognition. Therefore, the higher the difference in verification required for profit recognition versus recognition loss, the higher the level accounting conservatism (Watts,

2003a). As a result, earnings is likely to exist in the financial statements understated or too low in the current period and overstated against earnings in subsequent periods. Furthermore, it will reduce the power of earnings to predict future cash flows.

Accounting standard in Indonesia allows company to use conservatism principle, which is PSAK no. 9 paragraph 7 about receivables, in estimating allowance for bad debt which the bad debt expense got to be reported in the same period when the receivables transaction were incurred and bad debt expense will decrease net income amount on income statement in the current year. Jackson and Liu (2010) stated that allowance is conservative and it has become more conservative over time. It was achieved by firms repeatedly over accruing bad debt expense.

In a row of the IFRS convergence, the principle of conservatism was replaced by the principle of prudence which is not as extreme as the principle of conservatism. In the principle of prudence, revenue can recognize as soon as the terms of recognition are fulfil. Moreover, the term conservatism is still exist in the new regulation, such as in PSAK no. 14 about inventory which inventory cost presented in balance sheet based on the lowest value between the cost and the net realizable value. Subsequently, in PSAK no. 48 related to the impairment of assets which the impairment of assets is included as a loss that should be put in the comprehensive income statement. The use of conservatism is need to be considered because of the flexibility of management in present the financial

statements and considering some of cases about overstate financial statements representation that mislead the users of financial statements.

Many contradictions about the use of the conservatism in the financial statements presentation, Mayangsari and Wilopo (2002) also stated that conservatism is a controversial principle. The opponent argues that conservatism considered as a constraint in affecting the quality of financial statements, namely all of the information is not relevant and the earnings generated is not qualified. On the other hand, conservatism in accounting is useful to avoid the opportunistic behaviour of managers related to contracts using financial statements as a media contact. When the manager ownership is low, the manager tends to perform opportunistic earnings management measures such as earnings reported is high. Therefore, the shareholders assess the company has better performance. Furthermore, the proponent is not exaggerating in reporting the result in addition to decrease the misleading in making decisions. Conservatism also related to the political cost. Based on the positive accounting theory (Scott, 1997), larger firm will tend to be more conservative than smaller firm in order to decrease the political cost and to avoid the change of regulation or taxes by the government.

High index of conservatism can reduce abnormal accruals and also reduce the level of manipulation of financial statements. Integrity of financial reporting information not only in terms of the earnings or the quality of earnings because earnings still affected by accounting policy or accounting methods used. In the addition, the financial statements with the principle of conservatism is absolutely give no benefit to the management, as the party most benefited if there is any

manipulation of financial statements as actually applying conservatism, which reported a small earnings. Accounting standard setters have adopted several new accounting standards during the past several decades in order to improve the usefulness of financial reporting.

Many of these new standards involve an earlier recognition of expenses and losses usually called contingent liabilities, which requires the incorporation of future estimates into current earnings. For example, SFAS 121 (subsequently amended by SFAS 144) requires that capital assets are written down to its fair value only if the undiscounted future cash flows from the asset are less than its book value. The write-down amount is recognized as a loss in current earnings. Another case, PSAK no.9 paragraph 7 about receivables requires the estimation of allowance for bad debt have to be reported in the same period when the receivables transactions are made. This bad debt expense will decrease current earnings. Thus, current earnings reflect future cash flows under potentially adverse circumstances (Beaver and Ryan, 2005), although not under potentially favourable circumstances.

These accounting standards taken together result in an increase in conservatism in accounting numbers and thus increase the correlation between current earnings and future cash flows. This tends to enhance the relevance of earnings numbers because relevance is defined in SFAC No. 8 as the extents to which accounting numbers reflect future cash flows. In contrast, estimation of uncertain future cash flows imparts measurement error in current earnings and reduces reliability of current earnings in the Richardson et al. (2005) sense. Also,

anecdotally, the increasing litigious environment has probably led management to adopt a more conservative reporting stance. For example, management might have greater incentives to write off impaired assets and record option expenses based on more conservative future estimates.

Barth (2006) comments imply that by pre recognizing unrealized future expenses and losses, accounting conservatism could improve the relation between current earnings and future cash flows but at the cost of earnings predictability. Penman and Zhang (2002) found that use conservative accounting in investment activity will result in fluctuate earnings. The explanation is the conservative accounting practices will recognize the charge in loss in the period incurred otherwise recognize gains when actually been realized, therefore the resulting earnings will be lower in the period in question than if the company adheres applied optimistic principle. If in the next period, there is a decrease cost or income has been realized then the next period will be reported higher earnings for companies that adhere conservative principle. Therefore, reported earnings for companies that adhere conservative accounting tend to be more fluctuated than companies that adhere optimistic principle. The fluctuated earnings has a smaller ability to predict future cash flows than stable earnings

Bandyopadhyay, Chen, Huang and Jha (2010) provided different result they present robust evidence that an increasing level of accounting conservatism has led to an increase in relevance and decrease in reliability of current earnings. Relevance is measured as the ability of current earnings to predict future cash flows (Kim and Kross, 2002) and reliability is measured as the ability of current

earnings to predict future earnings (Richardson et al., 2005). Widya (2004) used the sample of listed manufacturing companies in Indonesia during 1995 until 2002. The result of the study indicates that in general, Indonesian firms select conservative accounting method (76.9%).

The principle of conservatism is a principle that still has the pros and cons. Therefore, it is necessary to do further study related to this principle whereas conservatism principle was replaced by prudence. However, conservatism is needed to be considered because in essence, prudence is likewise the principle about circumspection in which the term of conservatism still exists.

This research uses previous research as references by Bandyopadhyay, Chen, Huang and Jha (2010). This study uses data from Indonesian listed manufacturing companies during 2000-2010. The relation between earnings and future cash flows here will be shown by presenting the ability of current earnings to predict future cash flow. The ability of current earnings to predict future cash flows will be measured by using the multiple regression model. This research uses 11 years observation period before IFRS implementation, with the objective whether accounting conservatism will affect the relation between current earnings and future cash flows.

Based on the background, it can be seen that there are some disagreements between one and another previous researchers. Moreover, it comes up with different results and opinions. As Barth (2006) and Bandyopadhyay, Chen, Huang and Jha (2010) stated that accounting conservatism can increase the relation

between current earnings and future cash flows while Penman and Zhang (2002) found that accounting conservatism decrease the ability of earnings to predict future cash flows. The difference results of previous study is the motivation of this paper to give more information about the effect of accounting conservatism to the ability of current earnings to predict future cash flows in Indonesian manufacturing firms within 11 years period.

1.2. Problem Statement

Earnings is consist of accrual transactions which require to report revenue when its earned and expense when its incurred even though the money is not changed hands yet (cash will be distributed on the next period). Revenue and expense still have to be reported on its current income statement even the cash will be distributed in next period. Therefore, it will be affect the cash that in and out on the next period. It is can be said current earnings has an ability to predict future cash flows.

Accounting conservatism is the general principle of recognizing expenses and liabilities as soon as possible when there is uncertainty about the outcome. Under conservatism, if there is uncertainty about incurring a loss, the company should tend toward recording the loss. Conservatism requires company to make a prudent estimation about future losses and expenses that probably will be happen and it is tend to decrease the earnings number.

Moreover, previous research from Bandyopadhyay, Cheng, Huang and Jha (2010) found that an increasing level of accounting conservatism has led to an increase in the ability of current earnings to predict future cash flows while

Penman and Zhang (2002) stated that accounting conservatism decrease the ability of earnings to predict future cash flows.

According to the different result from the previous researchers, the main problem of this paper is:

Does accounting conservatism affect the ability of current earnings to predict future cash flows in listed manufacturing companies in Indonesia?

1.3. Research Objectives

The intention of this research is to show the effect of accounting conservatism towards current earnings to predict future cash flows in listed manufacturing companies in Indonesia.

1.4. Research Contribution

a. For Investors

This research gives benefits for investors' by giving information about the ability of companies in generating earnings and also will give information about the quality of earnings that can help investors and prospective investors to assess company's ability to generate cash flow in the future. It can help investors make a decision of investment.

b. For Creditors

This research gives benefits for creditors' by giving information about the current prospects cash to help creditors in assessing cash flow prospects of company. It can help creditors to make decision in give credits to companies

c. For Academic

This research is a device for the implementing of theories that have been gotten in college. Also further expectation, this research can acknowledge researcher more.

d. For Readers

This research is expected to give suggestions and more insights about the effect of accounting conservatism in the relation between current earnings and future cash flows in listed manufacturing companies in Indonesia.

1.5. Thesis Structure

This research is divided into 5 chapters, which are:

CHAPTER 1 INTRODUCTION

This chapter consists of the background of the research, problem statement, the objectives of the research, the contribution of the research and the thesis structure.

CHAPTER 2 THEORITICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

This chapter further explains theoretically about SFAC No. 8, accounting conservatism, earnings, cash flows, the relation between current earnings and future cash flows, the effect of accounting conservatism to current earnings in predict future cash flows, positive accounting theory, firm size, previous researches and hypothesis development.

CHAPTER 3 RESEARCH METHOD

This chapter consists of the scope of sample selection, data collection method, variables description which includes independent variable, dependent variable, moderating variable and control variable and also data analysis method that used in this study

CHAPTER 4 DATA ANALYSIS

This chapter contains the result and analysis from several tests includes normality test, multicollinearity test, heteroscedasticity test, autocorrelation test and hypothesis test. Those test aims to provide reliable evidence regarding the finding of this research.

CHAPTER 5 CONCLUSION AND LIMITATION

This chapter consists of the conclusion from the finding of this study, research limitation and the suggestion for further research.