CHAPTER II

THEORITICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1. Statement of Financial Accounting Concepts No. 8

This Concept consists of two chapters which are Chapter 1: The Objective of General Purpose Financial Reporting and Chapter 3: Qualitative Characteristics of Useful Financial Information. This Concept which includes two chapters of that new conceptual framework, supersedes FASB Concepts Statements No. 1, Objectives of Financial Reporting by Business Enterprises, and No. 2, Qualitative Characteristics of Accounting Information.

2.1.1. The Objective of General Purpose 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. Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors, lenders and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of future net cash inflows to the entity. Consequently, existing and potential

investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity. To assess an entity's prospects for future net cash flow, existing and potential investors, lenders and other creditors need information about the resources of the entity claims against the entity and how efficiently and effectively the entity's management and governing board have discharged their responsibilities.

Different types of economic resources affect a user's assessment of the reporting entity's prospects for future cash flows differently. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity's operations.

2.1.2. Qualitative Characteristics of Useful Financial Information

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. The fundamental qualitative characteristics are relevance and faithful representation.

2.1.2.1.Relevance

Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already are aware of it from other source. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

2.1.2.2.Materiality

Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

2.1.2.3.Faithful Representation

Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent (the term reliability was changed by faithful representation). To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. A neutral depiction is without bias in the selection or presentation of financial information.

A neutral depiction is not slanted, weighted, emphasized, deemphasized or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with

no errors in the process. In the context, free from error does not mean perfectly accurate in all respects.

2.2. Accounting Conservatism

2.2.1. The Principle of Accounting Conservatism

According to Hendriksen and Breda (1991), conservatism is generally used to mean that accountants should report the lowest of several possible values for assets and revenues and the highest of several possible values for liabilities and expenses.It also implies that expenses should be recognized sooner rather than later and that revenues should be recognized later rather than sooner. Therefore, net assets are more likely to be valued below current exchange prices than above them, and the computation of income is likely to result in the lowest of several alternatives of amounts. Thus, pessimism is assumed to be better than optimism in financial reporting.

Based on SFAC No. 2 (FASB, 1980), conservatism is a principle in financial reporting which intended to report lower earnings because of the economic and business activities covered by the uncertainty. This action done by take an advantage of opportunity to make a prudent estimation and through the selection of accounting method. Accounting conservatism states that if doubt exists between two acceptable alternatives, the accountant should choose the alternative that will result in lesser asset amount or lesser profit.

Basu (1997) defines conservatism as the practice of reducing earnings (and decrease in net assets) in response to bad news, but no increase in net income (net asset rising) in response to good news. Watts (2003) defines conservatism as the difference of verification required for recognition of profit and loss. Watts also stated that accounting conservatism arises from incentives related to the cost of the contract, litigation, tax and politic benefit for companies to reduce agency cost and reducing excessive payments to the parties, such as managers, shareholders and government. Besides that, conservatism also lead to understate earnings in the current period and able to drive overstate of earnings in the next period.

2.2.2. Application of Conservatism

Business and economic activities are surrounded by uncertainty, therefore, some prudent reaction have to be considered in financial accounting and reporting. Accounting conservatism appears in order to anticipate this uncertain condition by make a prudent estimation and the selection of accounting method. The application of this principle is the choice of accounting methods aimed at a method that reported earnings and assets lower or higher liabilities.

Company which sells good will find they have high account receivables balance, means that several customers owe the company cash in order to completely finalize the transaction. The unstable economic situation and the previous experience by the company may lead the

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company to take a prudent reaction by making estimation about the amount that may not be collected from the customers, it is called allowance for bad debt. This allowance for bad debt account is contra asset account which is deducted from account receivables. Therefore, this allowance for bad debt will be decreasing the net assets. The accounting conservatism play the role in this method, the company that choose to choose conservatism will make a high estimation of allowance for bad debt. Therefore, it would reduce the net assets even more. In other hand, the sales on credit will be affect the earnings number as well. The company will record this transaction as revenue on the income statement and the estimation of allowance for bad debt will make a credit balance on expense account. Therefore, this bad debt expense will decrease the earnings number. Jackson and Liu (2010) also stated that the allowance is conservative and that it has become more conservative over time.

Another application of conservatism is related to the contingent liability or contingent loss. A contingent liability is an existing item whose outcome is unknown because it is dependent on some future event. Generally, contingency in this case is considered loss contingency either because of a potential liability or potential asset impairment (Schiff and Rozen, 2012). The capital assets require to write 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 is related to the product warranty. If a company

promised to replace a defective unit at no cost to the customer within one year of purchase and company thinks some of unit will be returned and the company will estimate the payable, it would book a contingent liability of this amount on its balance sheet. Another case of contingent liability is relating with the lawsuit expenses.

2.2.3. Conservatism Measurement

The measurement of conservatism can be done by using several techniques. The five existing measures of accounting conservatism are:

1. **Basu's (1997) asymmetric timeliness measure**

    Basu's (1997) operationalization of accounting conservatism focuses on the implication that earnings will reflect bad news more quickly than good news. While the timeliness of accounting recognition of economic events has been well known, Basu was the first to link asymmetric timeliness with accounting conservatism. According to Basu's measure, the greater the asymmetric timeliness, the greater is the degree of conservatism in a firm. Empirically, the following cross sectional regression is used to assess the degree of conservatism:

$$EPS_{i,t}/ P_{i,t} = \alpha_0 + \alpha_1\ DR_{i,t} + \beta_0\ R_{i,t} + \beta_1\ DR_{i,t} + \varepsilon_{it}$$

$EPS_{i,t}$ = earnings per share for firm i year t.

$P_{i,t}$ = opening stock market price for firm i year t.

$R_{i,t}$ = stock market return for firm i year t.

DRi,t = dummy variable, with 1 if $Ri,t < 0$ (bad news) and 0 if $Ri,t > 0$ (good news).

If β_1 coefficient has a positive value and significantly differs from zero, then there is earnings conservatism in that company.

2. **Ball and Shivakumar's (2005) asymmetric cash flow to accruals measure**

Ball and Shivakumar (2005) developed this measure in order to estimate the degrees of accounting conservatism in private companies. Ball and Shivakumar measure is based on the following regression:

$$ACC_t \quad =\beta_0 + \beta_1 DCFOt + \beta_2 CFO_t + \beta_3 DCFO_t x\ CFO_t + \varepsilon_t$$

ACC_t = accruals measured as Δ inventory + Δ debtors + Δ other current assets - Δ creditors - Δ other current liabilities – depreciation.

CFO_t = cash flow for period t.

$DCFO_t$ = dummy variable that is set to 0 if $CFO_t \geq 0$, and set to 1 if $CFO_t < 0$.

3. **Market to Book (or Book to Market) ratio**

Beaver and Ryan (2000) found idea underlying the use of market to book (or book to market) as a measure of accounting conservatism is that, ceteris paribus, a conservative accounting system tends to depress the net book values of a firm relative to the firm's a true economic value. Therefore, a higher market to book (and a lower book to market) implies a higher degree of accounting conservatism and vice versa.

$$BTM_{i,t} = \alpha_t + \alpha_i + \sum_{j=0}^{6} \beta_j R_{t-j,i} + \varepsilon_{it}$$

$BTM_{t,i}$ = book to market ratio of firm i, at the end of year t.

α_t = year to year variation in the book to market common to the sample firms.

α_i = bias component of book to market for firm i.

$R_{t-j,i}$ = return on equity over each of the 6 preceding years.

B_j = regression coefficients on $R_{t-j,i}$.

4. **Penman and Zhang's (2002) hidden reserves measure**

   Penman and Zhang argue that accounting conservatism creates hidden reserves, the amount of which can be used to gauge the degree of conservatism in a firm. They argue that the higher the amount of the hidden reserves, the more conservative is the firm's financial reporting system. However, since hidden reserves are not explicitly reported in either the financial statements or anywhere else, they can only be estimated by the researchers themselves. Penman and Zhang (2002) constructed an index of conservatism, called the C score, which is calculated as:

$$C_{it} = ER_{it} / NOA_{it}$$

ER_{it} = estimated hidden reserves created by accounting conservatism. i indicates firms and t denotes balance sheet dates.

NOA$_{it}$ = net operating assets, the book value of operating assets minus operating liabilities, excluding financial assets and liabilities.

Estimating ER$_{it}$ still remains a challenge. Penman and Zhang (2002) use the following formula to estimate ER$_{it}$:

$$\textbf{ER}_{it} = \textbf{INV}_{it} + \textbf{RD}_{it} + \textbf{ADV}_{it}\textbf{(reserve)}$$

INV$_{it}$ = inventory reserve which the value under US GAAP of the LIFO reserve.

RD$_{it}$ = R&D reserve which calculated as the estimated amortised R&D asset.

ADV$_{it}$ = is an estimated brand asset

5. **Givoly and Hayn's (2000) nonoperating accruals measure**

Givoly and Hayn (2000) propose a measure of conservatism that focuses on nonoperating accruals as a subset of the firm's book value. The rationale behind using nonoperating accruals is that accounting conservatism uses the mechanism of accruals to defer the recognition of economic gains and accelerate the recognition of economic losses. Through such a process of delaying gains and accelerating losses, the level accumulated accruals in a firm gradually becomes more and more negative. The measurement of accounting conservatism using nonoperating accruals which is calculated as total accruals minus operating accruals.

$$\textbf{NOACC}_{i,t} = \textbf{TACC}_{i,t} - \textbf{OACC}_{i,t}$$

$NOACC_{i,t}$	= nonoperating accruals of firm i year t
$TACC_{i,t}$	= total accruals of firm i year t
$OACC_{i,t}$	= operating accruals, which is change in working capital of firm i year t

a. $TACC_{i,t}$ $= NI_{i,t} - CFO_{i,t}$

$NI_{i,t}$ = net income before extraordinary items of firm i year t

$CFO_{i,t}$ = cash flows from operation of firm i year t

b. $OACC_{i,t}$ $= (CA_{i,t} - CL_{i,t}) - (CA_{i,t-1} - CL_{i,t-1})$

$CA_{i,t}$ = current assets of firm i year t

$CL_{i,t}$ = current liabilities of firm i year t

$CA_{i,t-1}$ = current assets of firm i year t-1

$CL_{i,t-1}$ = current liabilities of firm i year t-1

All accrual variables are scaled by the average of total assets between the beginning of the year and the end of the year. If firms show negative nonoperating accruals, it implies that firm's exhibits conservatism. Positive nonoperating accruals means no conservatism or optimistic.

In this study, nonoperating accruals become a proxy for accounting conservatism. This model is a firm specific measure of conservatism, not market based, which makes it more widely applicable than the market based measures. Therefore, this model is the best model to capture a firm's conservatism.

2.3. Earnings

Earnings takes a central position in accounting. It is accounting's summary measure of a firm's performance. Accounting earnings is widely used in share valuation and to measure performance in management and debt contracts. Earnings information is a component of the company's financial statements, according to SFAC no. 8 earnings information has the following benefits: (1) to assess the performance of the management, (2) to help estimate the ability of earnings representative in the long term, predict earnings and assess the risk of earnings in investment or credit loans.

Accounting Terminology Bulletin (ATB) 2, states that the income and earnings as the number resulting from the reduction in income or operating income, cost of goods sold, other costs and losses. According to Suwardjono, definition of income adopted by the current accounting structure is that the accounting earnings are the difference between revenue and cost measurement. In this respect, some doubt this earnings figure as information for decision making. Hendriksen has put forward some criticism about the concept of accounting earnings. In terms of structure of the accounting, concept of earnings is the most acceptable because of the objectivity of measurement. In addition, the earnings accounting as currently defined are the benchmark of company performance and can be used by investors or creditors to predict cash flow.

2.4. Cash Flows

Financial statements issued by a company which is a result of the accounting process is intended to present financial information that can be used to meet the needs of external stakeholders. Financial statements consist of several reports such as balance sheet, income statement, cash flows and owner's equity statement accordance with applicable accounting standards. Cash flows information is useful as a basis to assess the ability of entity to generate cash and cash equivalents as well as assessing the cash needed to use those cash flows. Cash flows statement describes the historical changes in cash and cash equivalents are classified on the operating, investing and financing activities during one period.

According to PSAK, cash flows provide information that allows the users to evaluate the changes in net assets of the entity, the financial structure (liquidity and solvency) and the ability affects the amount and timing of cash flows in order to adjust the changing of circumstances and opportunities. Cash flows useful to assess the ability of the entities to generate cash and cash equivalents and allows users to develop some models to assess and compare the present value from future cash flows of the various entities.

Cash flows give potential benefits in make a decision, such as risk assessment, prediction of lending, companies appraisal and provide additional information on capital markets. Cash flows have the ability to increase the comparability of reporting the operating performance from

various entities. There are two methods in reporting cash flows from operating activities:

a. Direct Method: This method generate useful information in estimating future cash flows, because information about the major sources of gross cash receipts and gross cash expenditures can be obtained directly, either from the record of the company or from the sales adjustments, cost of goods sold and other accounts.

b. Indirect Method : In this reporting, companies should report the major groups of gross cash receipts separately from gross cash expenditure from investing and financing activities.

2.5. The Relation Between Current Earnings and Future Cash Flows

So far, financial statements particularly balance sheet and income statement still used to be a reliable element for the users to minimize the risk of uncertainty in make a decision. However, specifically on the reported income statement there is still a contradiction on the resulting conclusions related to the merit of the content on the information itself. However, there are some studies that support the value relevance of earnings in predicting future cash flows of the company (Barth, 2001) and Kim and Kross (2002) state that earnings has ability to predict future operating cash flow of the company and has more ability than the cash flow if the earnings disport into some components of accrual. In fact, Kim and Kross assert that the ability of earnings to predict cash flows has been increasing over time.

Earnings and cash flows as the indicator to determine the financial performance of firms whether getting better or worse, this condition gives an impact on the financial policy for the next activity (Parawiyati, 2000). Watson and Wells (2005) in their study stated that for profitable firms, earnings measurement is better in capturing company's performance than using cash flows measurement while companies that losing both earnings and cash flows cannot capture their performance. In this case, Kim and Kross also distinguish between firms with positive earnings and firms with negative earnings, the result states that the relationship between earnings and future cash flows remain strong while the relationship between current cash flows and future cash flows is neither increasing nor decreasing.

Greenberg et al. (1986) investigated the models containing only current earnings and only current cash flow with the horizons period of one to five years and use multiple lag periods of two to three years to predict future cash flows. Their findings show that the majority of companies indicate current earnings are a better predictor of future cash flows than current cash flows. Later, Lorek and Willinger (1996) and Dechow et al. (1998) find the same result. Dechow modeled cash flows and the accrual process related to accounts receivable, account payable and inventory to derive the prediction that current earnings is the best predictor of future cash flows. They reported that the firm specific variation in cash flows forecast errors based on aggregate earnings are significantly lower than that based on cash flows.

2.6. **The Effect of Conservatism to Current Earnings in Predict Future Cash Flows**

Among the researchers, the principle of accounting conservatism is still considered as a controversial principle. On the one hand, accounting conservatism is considered as constraints that affect the quality of financial statements while on the other hand, accounting conservatism is useful to avoid manager opportunistic behaviour of contracts relating to the use of financial statements as media contracts (Watts, 2007).

There are pros and cons about conservatism, some researchers directly examine the benefits of conservatism in financial statement presentation. Studies show that conservatism is not useful for users especially investors, investigated by Greenball (1969), Basu (1997) and Penman and Zhang (2000) stated in Milne (2000). Researchers stated that conservatism will cause low quality of earnings. Researchers that prove conservatism is beneficial, conducted by Feltham and Ohlson (1996) and Ahmed et al. (2000). They prove that earnings and assets calculating by accounting conservatism can be used to assess the company performances.

Sekar and Wilopo (2005) state that the principle of conservatism is useful because it can be use to predict future conditions that accordance with the objectives of financial statements. Financial statements were prepared on PSAK established by the agency have an authority to set the standard. There are several options in PSAK that can be used by companies to prepare the financial report. Companies have some freedom

in choosing one of several alternatives are offered in accounting standards considered in accordance with the company's conditions.

Penman and Zhang (2002) found that use conservative accounting in investment activity will result with fluctuating earnings. The explanation is the conservative accounting practices will recognize the charge in loss in the period incurred otherwise recognize gain 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. Fluctuate earnings have a lower predictive power than stable earnings to predict future cash flows.

Bandyopadhyay, Chen, Huang and Jha (2010) have different opinion and 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). They also reported that usefulness of earnings is positively related to reliability, but not to relevance and the

earnings usefulness does not increase with an increase in the ability of earnings to predict future cash flows.

Widya (2004) have examined the application of conservative accounting in Indonesia. Widya reported 76.9% of the 75 companies on Jakarta Stock Exchange in the period of 1995 - 2002 have applied conservatism in accounting. The practice of conservatism can occur due to accounting standards applicable in Indonesia allow the company to choose several method of accounting that are allowed in the same situation. For example, PSAK No. 9 paragraph 7 related to estimating allowance for bad debt, PSAK No. 14 on inventory related to the selection of inventory cost and PSAK No. 48 related to impairment of assets.

2.7. Positive Accounting Theory

According to Scott, positive accounting theory is concerned with predicting such actions as the choices of accounting policies by firm managers and how managers will respond to proposed new accounting standards. Positive accounting theory assumes that managers are rational and will choose accounting policies in their own best interests if able to do so. That is, managers maximize their own expected utility. Thus, positive accounting theory does not assume that the manager will simply act so as to maximize firm profits. Rather, the manager will only maximize profits if he/she perceives this to be in his/her own best interests.

The optimal set of accounting policies for the firm then represents a compromise. On the other hand, tightly prescribing accounting policies

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beforehand will minimize opportunistic accounting policy choice by managers, but incur costs of lack of accounting flexibility to meet changing circumstances, such as new accounting standards that affect net income. On the other hand, allowing the manager to choose from a broad array of accounting policies will reduce costs of accounting inflexibility but expose the firm to the costs of opportunistic manager behaviour.

The predictions made by positive accounting theory are largely organized around three hypotheses, formulated by Watts and Zimmerman (1986). These hypotheses are given in their opportunistic form, this is how they have most frequently been interpreted. By opportunistic form we mean that managers choose accounting policies in their own best interests, which may not necessarily also be in the firm's best interests.

2.7.1. Bonus Plan Hypothesis

Managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period. It is use to get more bonus, choosing accounting methods that increase current reported earnings. Because of the nature of the accrual process, this will tend to lower future reported earnings and bonuses.

2.7.2. Debt Covenant Hypothesis

The closer a firm is to violation of accounting-based of debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the

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current period. The reason is that increasing reported net income will reduce the probability of technical default. Most of debt agreements contain covenants that the borrower must meet during the term of the agreement. For example, a borrowing firm may covenant to maintain specified levels of interest coverage, debt to equity, working capital and shareholders' equity. If such covenants are violated, the debt agreement may impose penalties, such as constraints on dividends or additional borrowing. Therefore, the manager may object to accounting policies that increase earnings volatility.

2.7.3. Political Cost Hypothesis

The greater the political costs (taxes, regulations) faced by a firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods. The political cost hypothesis introduces a political dimension into accounting policy choice. For example, political costs can be imposed by high profitability, which may attract media and consumer attention. Such attention can quickly translate into political heat on the firm, and politicians may respond with new taxes or other regulations. Large firm may be held to higher performance standards, for example with respect to environmental responsibility, simply because they are felt to be large and powerful. If the large firms are also highly profitable, such political

costs will be magnified.Therefore, the manager objects to adopt income decreasing accounting policies in an attempt to decrease political costs.

These three hypotheses form an important component of positive accounting theory. Note that all lead to empirically testable predictions. Managers of firms with bonus plans are predicted to choose less conservative accounting policies than managers of firms without such plans. Similarly, the debt covenant hypothesis predicts that managers of firms with high debt to equity ratios will choose less conservative accounting policies than managers of firms with low ratios. The political cost hypothesis predicts that managers of very large firms will choose more conservative accounting policies than managers of smaller firms.

Conservative accounting can also contribute to efficient contracting, as argued by Watts (2003). Consider the debt covenant hypothesis. Debtholders will suffer if the firm cannot meet its interest and principal payments. Consequently, they will benefit if the firm uses conservative accounting, due to a reduced likelihood that the firm will make excessive dividend payments, conservative accounting makes it more difficult for the manager to pay excessive dividends by introducing a persistent downward bias into retained earnings. Furthermore, conservative accounting increases the protection provided by debt covenants. For example, suppose the debt agreement includes a covenant whereby the firm must maintain a debt to equity ratio of not more than

two, otherwise no dividends can be paid. Since conservative accounting lowers the denominator, it increase the ratio. Thus, in real terms, the firm must retain more net assets to avoid violation, increasing the debtholders' security. This increased security increases the firm's future cash flows by enabling it to issue its debt at a lower interest rate than otherwise. Another case, conservative accounting which reported in smaller earnings will reduce firm's political cost.

2.8. Firm Size

Definition of firm size according to Riyanto (1999) namely, the size of the firm which can be defined according to the value of firm's equity, sales or total assets. The relationship between earnings and cash flows over time for large, established firms might differ from smaller firms, which are more likely growth firms (Kim and Kross, 2002). Kim and Kross divide their sample into three equal groups which are small, medium or large based on firm size measured by the book value of assets. They found that the relationship between earnings and future cash flows is not deteriorating for any group of firms and this relationship is significantly increasing over time for small and medium-sized firms. Firm size is the most consistent variable which significantly affects the broad disclosure of previous researches. The other previous researches from Brochet and Nam (2008) stated with respect to firm size, larger firms are presumably more mature firms with more stable financial condition which can be predicted more easily and other research from Pae and Thornton

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(2006) implied natural log of size is significantly positively related to the prediction error.

Therefore, by looking at the result of previous researches, this study uses firm size as a control variable. Firm size here is used to control the relation between current earnings and future cash flows. Firm size can be seen from a firm's total assets. Total asset used as a proxy for firm size because total asset is a resource owned by a company that use to generate revenues which will provide future economic outcome.

2.9.   Previous Researches

Greenberg et al. (1986) investigated the models containing only current earnings and only current cash flow with the horizons period of one to five years and use multiple lag periods of two to three years to predict future cash flows. Their findings show that the majority of companies indicate current earnings is a better predictor of future cash flows than current cash flows. Later, Lorek and Willenger (1996) and Dechow et al. (1998) find the same result. Kim and Kross (2002) reported the relation between earnings and future cash flows has been increasing over time. The researcher holds only for CFO forecasts from one year ahead to three years ahead. It is possible that the ability of earnings to predict future CFO deteriorates dramatically beyond a three year horizon.

Conservatism is an important feature of financial reporting and practices (Givoly and Hayn, 2000). This principle has become an important qualitative characteristic of accounting earnings is one (Watts,

2003). Conservative accounting would affect earnings prediction power (Penman and Zhang, 2002). This research said that conservative accounting with investment growth depresses earnings and accounting rates of return, and creates unrecorded reserves. Firm slowing investment release these reserves, creating earnings and higher rates of return. If the change in investment is temporary, then the effects on earnings and rates of return are temporary, leading to lower quality or less sustainable earnings.

Other researchers, Basu (1997) interpreted conservatism as the tendency of accountants to require a higher degree of verification for recognizing good news than bad news in financial statements. Because of the influence of conservatism, it is argued that earnings would reflect bad news timelier than good news, leaving the loss recognition typically be earlier than the gain recognition. According to researcher, the asymmetry in the recognition of gains and losses lead to systematic differences between bad news and good news periods in the timeliness and persistence of earnings.

Widya (2004) have examined the application of conservative accounting in Indonesia. Widya reported 76.9% of the 75 companies on the Jakarta Stock Exchange in the period of 1995-2002 applied conservative accounting method. The influencing factors of the selection of the method are ownership structure, political cost and growth, while the

debt covenant with the proxy of leverage is not the factor influencing the firms' choice of it because the contract rarely takes place in the country.

Bandyopadhyay, Chen, Huang and Jha (2010) present robust evidence that an increasing level of accounting conservatism during 1973 – 2005 period has led to an increase in relevance and a decrease in reliability of current earnings. Relevance is measured as the ability of current earnings to predict future cash flows (Kim and Kross 2002). Reliability is measured as the ability of current earnings to predict future earnings (Richardson 2005). The researchers also contribute to the debate on the costs and a benefit of conservative accounting by showing the increasing of conservatism enhances relevance at the cost of reliability. The relation among conservatism, relevance, reliability and usefulness suggest that the adoption of an increasing number of conservative accounting standards has a possible adverse impact on earnings usefulness through negative effect on reliability.

Table 2.1

Summary of Previous Researches

Research's Title	Research's Result
The Ability of Earnings to Predict Future Operating Cash Flows Has Been Increasing – Not Decreasing	The relation between earnings and future cash flows has been increasing over time.
Accounting Conservatism, the Quality of	Conservative accounting would influence

Earnings, and Stock Returns	earnings prediction power
The Conservatism Principle and The Asymmetric Timeliness of Earnings	The asymmetry in the recognition of gains and losses lead to systematic differences between bad news and good news periods in the timeliness and persistence of earnings
Analisis Faktor - Faktor yang Mempengaruhi Pilihan Perusahaan Terhadap Akuntansi Konservatif	This research reported that 76.9% of the 75 companies on the Jakarta Stock Exchange in the period of 1995-2002 applied conservative accounting method.
Accounting Conservatism and Temporal Trends in Current Earnings' Ability to Predict Future Cash Flows versus Future Earnings: Evidence on the Trade-off between Relevance and Reliability	The researchers present robust evidence that an increasing level of accounting conservatism during 1973 – 2005 period has led to an increase in relevance and a decrease in reliability of current earnings.

2.10. Hypothesis Development

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. 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 is consist of accrual transactions which

require to report revenue when its earned and expense when its incurred even the money is not changed hands yet. Revenue and expense have to be reported on its current income statement even the cash will distributed in the next period. Therefore, it can be said that current period of earnings can be used as the predictor of future operating cash flows.

Accounting conservatism appears because of the economic and business conditions are surrounded by the uncertainty. Conservatism is generally used to mean that accountants should report the lowest of several possible values for assets and revenues and the highest of the several possible values for liabilities and expenses (Hendriksen and Breda, 1991). This action done by take an advantage of opportunity to make a prudent estimation and through the selection of accounting method.

Company which sells good will find they have high account receivables balance, the unstable economic condition and previous experience may lead the company to take a prudent estimation about the amount that may not be collected from the customers. This amount will be decrease the net assets balance and will be reported as expense on income statement balance. Therefore, it will be affect the earnings number and directly will be affect the relation between earnings to predict future cash flows.

Moreover, the implication of accounting standards in Indonesia allows the managers to apply conservatism. Managers actually have their own reason in applying conservatism. This action seems as to have

correlation with the practice of reducing earnings (and decrease in net assets) in response to bad news, but no increase in net income (net asset raising) in response to good news. (Watts, 2003) stated that accounting conservatism arises from incentives related to the cost of the contract, litigation, tax and politic benefit for companies to reduce agency cost and reducing excessive payments to the parties, such as managers, shareholders and government. By doing conservatism, company will report smaller earnings in expects to have reduction in political cost. Based on political cost hypothesis in positive accounting theory (Scott, 1997), the larger a firm the more likely a firm tend to be more conservative in order to decrease the political costs.

Furthermore, some researches about the effect of accounting conservatism and the relation between current earnings and future cash flows found that conservatism affects the ability of current earnings to predict future cash flows. Greenberg et al. (1986) show that the majority of companies indicate current earnings is a better predictor of future cash flows than current cash flows. Kim and Kross (2002) reported that the relation between earnings and future cash flows has been increasing over time.

Conservative accounting would affect earnings prediction power (Penman and Zhang, 2002). Widya (2004) have examined the implication of conservative accounting in Indonesia. Widya reported 76.9% of the 75 companies on the Jakarta Stock Exchange in the period of 1995-2002

applied conservative accounting. Bandyopadhyay, Chen, Huang and Jha (2010) presented strong evidence that an increasing level of accounting conservatism during 1973 – 2005 period has led to an increase in relevance of current earnings. Relevance is measured as the ability of current earnings to predict future cash flows.

This research will use journal from Bandyopadhyay, Chen, Huang and Jha (2010) as references. These research used COMPUSTAT industrial and CRSP files for the period from 1973 to 2005 as sample while this research will use listed manufacturing companies in Indonesia during period from 2000 to 2010 before IFRS implementation in Indonesia, with the objective whether accounting conservatism affects the relation between current earnings and future cash flows. This statement shown by present the ability of current earnings to predict future cash flows. This research uses multiple regression model in order to test the hypothesis and nonoperating accruals model by Givoly and Hayn (2000) as a proxy of accounting conservatism. Based on the explanation above, formulation of hypothesis proposed for this research is as follows:

H1 : Accounting conservatism affects the relation between current earnings and future cash flows