CHAPTER I

INTRODUCTION

1.1 Background

Financial report is the final result of the accounting process. Financial report describes the financial conditions in a certain period. The general purpose of financial report is as written on the Statement of Financial Accounting Concepts (SFAC) No.8 chapter 1 about the Objective of General Purpose Financial Reporting that:

> "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit." (SFAC No.8 chapter 1: OB2).

In 2009, the Indonesian Institute of Accountants (Ikatan Akuntan Indonesia) demanded all publicly traded firms to apply International Financial Accounting Standard-based accounting standard (IFRS-based PSAK) in preparing their financial statements. The implementation of IFRS is one of the efforts to meet the needs of global accounting and has been fully adopted since 1 January 2012. IFRS is issued by the International Accounting Standard Board (IASB), which has taken over the responsibilities of the International Accounting Standard Committee (IASC) since 2001. The mandatory adoption of IFRS is set as a result of Indonesian membership in G20 Forum. In a meeting of G20 Forum members, held on 15

November 2008, it was agreed that the global IFRS adoption is aimed to strengthen transparency and accountability of financial statements.

The adoption of IFRS causes some changes including more principles-based standards, more use of fair value, and more practice of professional judgment (Sinaga, 2012). Before the convergence of IFRS, PSAK 30 (1994) about leasing is more rules-based standard. Rules-based standard is able to improve the consistency and comparison between companies throughout time. However, rules-based standards become less relevant because of the inability of the standards to reflect the real economic event between differenct entities. One common argument against rules-based standard is that they provide executives with the opportunity to engage in transaction structuring and thus induce bias in financial reporting information (Nelson et al, 2002). These conditions will make difference in earning quality.

Different from rules-based standards, principles-based standards make a number of estimations that should be justifiable and require more professional judgment (Schipper, 2003). The example is IAS 17 adopted in PSAK 30 (2011) about leasing. Principles-based standards reflect more real transactions or economic event. The principles-based nature of IFRS encourages firms to report accounting information that is better to reflect the economic substance over form and therefore promote greater transparency (Maines et al. 2003 in Chua et al. 2012). Thus, it is logical to argue that differences exist in the financial report quality resulted by IFRS-based accounting standards and by the previous accounting standards. A more subjective standard with principles-based nature causes inconsistent judgment. As a result, larger opportunities for practicing earnings management are possible when inconsistent judgment is carried out (Schipper and Nelson, 2003).

Convergence of PSAK to IFRS introduces the use of more fair value. Fair value accounting refers to the practice in which companies increase or decrease the value of their assets or liabilities in the financial statements in order to reflect the changes in the market prices of these assets (IASB 2003). The ability to reflect recent economic situation is the benefit of fair value (relevance). On the other hand, fair value also has shortcomings. One of them is the difficulty in determining the fair value of assets or liability which has no active market value. As the consequence, the appraisal tends to be subjective because there is no standard for assessment. Therefore, more fair value in the adoption of IFRS into PSAK could cause differences of earnings quality compared to before the adoption of IFRS.

The implementation of IFRS in Indonesia is expected to give differences in the quality of financial reports and earnings quality of companies in Indonesia. However, several researches that have been done in Indonesia are not yet able to explain whether IFRS-based accounting standards could cause differences in earnings quality. For instance, the research conducted by Santy, et. al. (2012) suggests that adopting IFRS would not affect earnings management action of banking companies in Indonesia. Another study done by Handayani (2014), it was also found that the adoption of IFRS would not affect accruals and real activity earnings management of manufacturing companies in Indonesia. Nevertheless, the research conducted by Narendra (2013) showed that the adoption of IFRS had some positive effects for earnings management although the decreasing level of earnings management is not too significant. Wan Abidah et al (2013) found that IFRS adoption is associated with higher quality of reported earnings. It is found that earnings reported during the period after the adoption of IFRS is associated with lower earnings management and higher value relevance.

The changes of the regulation motivate researcher to examine the difference of earnings quality before and after the adoption of IFRS. To determine the effect of IFRS adoption on earnings quality, the researcher examine whether the level of earnings management is significantly different after the adoption of IFRS. The researcher uses Real Estate, Property and Building Construction Companies that are listed on Indonesia Stock Exchange as the object of this study because the value of property is always increasing every year. Also, better judgment to appraise the value of property is more desired. The study covers two periods, two years before the adoption (2010-2011) and two years after the adoption (2012-2013).

1.2 Problem Statement

The adoption of IFRS into PSAK has led to some fundamental changes in principles-based and fair value usage. In principles-based standards, accountants make a number of estimation that should be justifiable and require more professional judgment (Schipper, 2003). The principles-based nature of IFRS encourages firms to report accounting information that reflects the economic substance over form better and therefore promotes greater transparency (Maines et al. 2003 in Chua et al. 2012). Meanwhile, principles-based accounting standards are characterized by the lack of bright lines, reduced implementation guidance, allowing few exceptions in application, and a focus on conceptual definitions of assets and liabilities (SEC 2003). Besides that, Robert Herz (2003), the former SEC chairman, noted that standards should not be principles-based because principles-based standards provide management with more discretion, which could be misused. More subjective standards with principles-based nature cause inconsistent judgment. As a result, larger opportunities for practicing earnings management are possible when inconsistent judgment is carried out (Schipper and Nelson, 2003). By applying principles-based standards, the earning quality of the company is expected to be different.

Using fair value accounting, companies measure and report the value of certain assets and liabilities on the basis of their actual or estimated fair market prices. The ability to reflect recent economic situation is the benefit of fair value (relevance). However, Kazmouz (2010), who was investigating the effect of fair value application towards companies in United Kingdom, argued that the fair value of financial statements could reflect the firm's economic reality, which enhances efficiency of the invested capital, but also management efficiency, financial statements harmonization, and the justness of income distribution. Referring to these changes of principles-based standards and use of fair value, this research tries to examine whether changes in accounting standards will give impact to earnings quality changes before and after IFRS adoption. Thus, the research question is:

- Is the earnings quality significantly different before and after IFRS adoption for listed real estate, property and building construction companies on IDX?

1.3. Research Scope

Variables used in this study are International Financial Accounting Standard (IFRS) and earnings quality. The IFRS period will be divided into two groups as follows.

1. The year before IFRS adoption. The years of 2010 and 2011 are chosen because the two years are the nearest years before IFRS is mandatorily adopted on January 1, 2012.

2. The year after IFRS adoption. The years after IFRS adoption are 2012 and 2013.

1.4. Research Objective

The fundamental changes in accounting standards after the adoption of IFRS into PSAK are suspected as causes of the difference in earnings quality. This research aims to provide empirical evidence about the difference in the earnings quality before and after the adoption of IFRS in Indonesia real estate, property and building construction.

1.5. Contribution of Research

This research titled "THE ADOPTION OF IFRS AND EARNINGS QUALITY OF INDONESIAN REAL ESTATE, PROPERTY AND BUILDING CONSTRUCTION COMPANIES" is expected to give contributions for each of the following parties.

(a) For the writer

This research is expected to increase the writer's understanding on the current issue in financial accounting, specifically the mandatory adoption of IFRS in relation with earnings quality. It is expected that the writer is able to acquire the knowledge. Hence, the writer will gain experience in real work.

(b) For the university

It is hoped that this research has the quality and capability to serve as one of the references in the library and as a literature for next researches with similar variables.

(c) For practitioners

This research is hoped to be useful for accounting practitioners such as accountants, investors, and business entity to help them reach the goal in relation to the investing climate.

1.6. Systematic Content

CHAPTER I: INTRODUCTION

This chapter describes the background of the research, problem statement of the research, objectives of the research, contribution of the research, data analysis process of the research, and systematic writing of the contents of the research.

CHAPTER II: THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

This chapter consists of relevant theories, concepts, and literature about IFRS convergence and earnings quality. Further, it presents several related previous research that will be used as a reference in hypothesis development and discussion of the data analysis results.

CHAPTER III: RESEARCH METHODOLOGY

This chapter explains the methods in selecting and sampling the data population, collecting the financial information, measuring earnings quality, and analyzing the data. It includes the definition of earnings quality and measurement of its variables using previously proposed models.

CHAPTER IV: DATA ANALYSIS AND DISCUSSION

This chapter presents the results from data analysis and the discussion of the results based on the hypothesis and previous research.

CHAPTER V: CONCLUSION

The final chapter presents several conclusions based on the hypothesis and results. It will also indicate the limitations of the research and include several suggestions for future research.