CHAPTER II

THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1 Theoretical Background

2.1.1 Financial Report

Financial report is a structured presentation of financial position and financial performance of an entity. The purpose of a financial report is to provide information about the financial position, financial performance and cash flow of an entity that is beneficial for most of the users of financial reports in economic decision (IAI, 2012). The primary objective of financial reporting is to provide useful information that is useful for make decision.

SFAC 1 articulates this importance of financial reporting through three basic financial reporting objectives. First, financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. The first objective specifies a focus on investors and creditors. In addition to the importance of investors and creditors as key users, information to meet their needs is likely to have general utility to other groups of external users who are interested in essentially the same financial aspects of a business as are investors and creditors (McGraw-Hill in Adisty, 2014).

Second, Financial reporting should provide information to help present and potential investors and creditors and other users to assess the amounts, timing, and uncertainty of prospective cash receipts. It means that since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise. This second objective refers to the specific cash flow information needs of investors and creditors (McGraw-Hill in Adisty, 2014).

Third, financial reporting should provide information about the economic resources of an enterprise; the claims to those resources (obligations); and the effects of transactions, events, and circumstances that cause changes in resources and claims to those resources. This third objective emphasizes the need for information about economic resources and claims to those resources. This information would include not only the amount of resources and claims at a particular point in time but also changes in resources and claims that occur over periods of time. This information is key to predicting future cash flows (McGraw-Hill in Adisty, 2014).

2.1.2 International Financial Reporting Standard (IFRS)

The International Accounting Standards Board (IASB) publishes IFRS. IASB, formerly International Accounting Standards Committee (IASC), is the independent standard setter for the private sector founded in 1973 by the organization of accounting professionals in nine countries (Choi, 2008).

IFRS as global accounting standards have also been accepted and supported by more than 120 countries and international bodies in the world. The purpose is to ensure the financial statements of companies have high quality of information. For example:

1. Transparent for the users and comparable in the following period
2. Providing the starting point sufficient to IFRS
3. Producible with non-exceeding cost to be beneficial to users

There are two kinds of strategy to adopt IFRS, namely the big bang strategy and gradual strategy. In the big bang strategy, full adoption of IFRS is without going through stages. Developed countries such as Australia have done this strategy. While, the approach to the gradual strategy is the adoption of IFRS done progressively. Most of this strategy is conducted by developing countries such as Indonesia. According to the Indonesian Financial Accounting Standards Board (Dewan Standar Akuntansi Keuangan or DSAK), the level of IFRS adoption can be classified into five categories:

1. Full Adoption

   A country adopts all IFRS standards, translates and applies it into language used in the country.

2. Adopted

   A country applies IFRS by adapting to the conditions of the country. If there is a standard that is not relevant with the condition of the country, it will be changed based on the needs of the country.

3. Piecemeal

A country only adopts a number of certain IFRS standards and chooses some particular paragraphs that are suitable to the condition of the country.

4. Convergence

A country takes standards that refer to certain paragraphs of IFRS only, which are made by the accounting board. This kind of IFRS adoption is applied in Indonesia's PSAK.

5. No adoption

A country does not adopt IFRS. It happens when IFRS standards are very different from the regulations of the country.

2.1.3 The Development of Accounting Standards in Indonesia

The development of accounting standards in Indonesia has begun from 1957 until now. There are three historical developments of accounting standards in Indonesia. First, started ahead of the capital market in Indonesia in 1973. At that time, Indonesia Accounting Standards Board modified accounting standards in one book named Indonesian Accounting Principles (PAI). Second history began in 1984 where at that time, committee of PAI revised the fundamental 1973 and modified in Indonesian Accounting Principles 1984. The purpose of the revision was to adjust accounting standards with the development of business. Next in 1994, IAI revised Indonesian Accounting Principles 1984 and changed it into Financial Accounting Standards (SAK) per 1 October 1994. Since 1994, IAI has decided to perform harmonization with International Accounting Standards in the development of its standard. The next development changes from harmonization into adaptation, after that becomes adoption in order to converge with IFRS (Bangun, 2014).

Financial accounting standards are being revised alongside the addition of new standards since 1994. The revision process has been done seven times, i.e. on 1 October 1995, 1 June 1996, 1 June 1999, 1 April 2002, 1 October 2004, 1 September 2007, and 1 July 2009. Until the end of 2008, the number of IFRS standards adopted was 10 out of 33 standards. The whole implementation of IFRS began in 2012.

2.1.4 The Convergence of IFRS in Indonesia

Based on the roadmap of IFRS convergence into PSAK, Indonesia started to implement full IFRS into PSAK on 1 January 2012. Based on The Financial Accounting Standard Board (Dewan Standar Akuntansi Keuangan or DSAK), the process of adoption of IFRS into PSAK 2008 started in 3 phases:

1. Adoption phase (2008-2010). This stage begins with the adoption of IFRS into PSAK and the preparation of the infrastructure that is needed in the adoption process. At the end of the adoption stage, the impact of PSAK adoption is evaluated and managed.
2. Final preparation phase (2011). In this stage, the process is done in the form of the settlement and the preparation of the infrastructure, which has been done, and the application of PSAK number is gradually based on IFRS.
3. Implementation (2012). In this stage, IFRS is implemented into PSAK gradually and the impact of the implementation is evaluated.

Below is the table of PSAK and their effective dates. The table below is used as the basis of determining years used for the sample period after IFRS adoption.

Table 2.1

Effective Date of IFRS-based PSAK

Effective Date	PSAK Number
January 1, 2011	• PSAK 1: Penyajian Laporan Keuangan • PSAK 2: Laporan Arus Kas • PSAK 3: Laporan Keuangan Interim • PSAK 4: Lapora Keuangan Konsolidasian dan Laporan Keuangan Tersendiri • PSAK 5: Segmen Operasi • PSAK 7: Pengungkapan Pihak- pihak Berelasi • PSAK 8: Peristiwa Setelah Periode Pelaporan • PSAK 12: Bagian Partisipasi dalam Ventura Bersama • PSAK 15: Investasi pada Entitas Asosiasi • PSAK 19: Aset Tak Berwujud • PSAK 22: Kombinasi Bisnis • PSAK 23: Pendapatan • PSAK 25: Kebijakan Akuntasi, Estimasi Akuntansi, dan Kesalahan • PSAK 48: Penurunan Nilai Aset • PSAK 57: Provisi, Liabilitas Kontijensi dan aset kontijensi • PSAK 58: Aset Tidak Lancar yang Dimiliki untuk Dijual
January 1, 2012	• PSAK 10: Pengaruh Perubahan Kurs Valuta Asing • PSAK 13: Properti Investasi • PSAK 16: Aset Tetap • PSAK 18: Akuntansi dan Pelaporan Program Pembuat Manfaat Purnakrya • PSAK 24: Imbalan Kerja • PSAK 26: Biaya Pinjaman • PSAK 28: Akuntansi Kontrak Asuransi Kerugian • PSAK 30: Sewa • PSAK 33: Aktivitas Pengupasan Lapisan Tanah dan

	Pengelolaan Lingkungan hidup pada Pertambangan Umum • PSAK 34: Kontrak Konstruksi • PSAK 28:Akuntansi Kontrak Asuransi Jiwa • PSAK 45: Pelaporan Keuangan Entitas Nirlaba • PSAK 46: Pajak Penghasilan • PSAK 50: Instrumen Keuangan: Penyajian • PSAK 53: Pembayaran Berbasis Saham • PSAK 55: Instrumen Keuangan: Pengakuan dan Pengukuran • PSAK 56: Laba per Saham • PSAK 60: Instrumen Keuangan: Pengungkapan • PSAK 61: Akuntansi Hibah Pemerintah dan Pengungkapan Bantuan Pemerintah • PSAK 62: Kontrak Asuransi • PSAK 63: Pelaporan Keuangan dalam Ekonomi Hiperinflasi • PSAK 64: Pelaporan Keuangan dalam Ekonomi Hiperinflasi

Source: Statement of Financial Accounting Standard by Indonesian Institute of Accountant, 2012

According to Kurniawan (Chairman of IFRS Implementation Indonesian Institute of Accountant), the convergence of IFRS gives some benefits, namely:

1. Increasing the quality of accounting standard (SAK)
2. Decreasing the cost of SAK
3. Increasing the credibility of financial report
4. Increasing the comparability of financial report
5. Increasing transparency of financial report
6. Increasing efficiency in making financial report

Kurniawan also said Indonesia has certainly some obstacles when conduction convergence. The followings are some of the obstacles faced by Indonesia when applying the convergence of IFRS.

1. The accounting standards board lack of human resources.

2. IFRS has changed too quickly when the adoption process is still going on, the IASB is already in the process of replacing IFRS.

3. Language barrier, every IFRS standard have to translate into bahasa.

4. The infrastructures of accountants are not ready yet. Adopting IFRS requires many new accounting methods.

5. The readiness of accounting lecture to change the standard into IFRS

6. The government support to issue the convergence.

2.1.5 Principle Based

IFRS is known as the principles-based while U.S. GAAP is rules-based standards. According to Securities and Exchange Commission (SEC, 2003), the main characteristic of rules-based standards is bright lines that give detailed implementation of financial reporting. Bright lines have quantitative limitations that must be fulfilled while principles-based standards do not give any detail. Principles-based standards contain some valuation or better known as professional judgment.

The difference between rules-based and principles-based standards can be seen in the standard about leasing. Accounting standards that regulate leasing in Indonesia can be found in PSAK 30 (2011) adopted IAS 17 per 1 January 2009. The regulation about leasing in PSAK 30 (1994) refers to the PAI statement 6 (1990). PSAK 30 (1994) has been revised into PSAK 30 in 2007 and PSAK 30 (2011). PSAK 30 in 2007 already refers to IAS 17 (2003) so PSAK 30 (2011) does not have any significant difference from PSAK 30 in 2007 because it is also adopting IAS 17 per 1 January 2009.

The difference between the standards about leasing is that PSAK 30 (1994) refers to PAI statement 6 (1990) while PSAK 30 (2011) adopts IAS 17. The difference among the standards can be seen in the table below:

Table 2.2

The Comparison of Accounting Standard for Leasing
In PSAK 30 (2011) that adopt IAS 17 (2009) and PSAK 30 (1994) that adopt PAI 6 (1990)

Criteria	PSAK 30 (2011) adopting IAS 17 per January 2009	PSAK 30 (1994) refers to Accounting Principle Indonesia (PAI) statement 6 (1990)	Difference
Leasing Classification	PSAK 30 (2011) par 10 lease being classified as a finance lease include the following: 1. the lease transfers ownership of the asset to the lessee by the end of the lease term 2. the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised 3. the lease term is for the major part of the economic life of the asset, even if title is not transferred 4. at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset 5. the lease assets are of a specialized nature such that only the lessee can use them without major modifications being made	PSAK 30 (1994) Ch 2 par 3 Being classified as a finance lease include the following: 1. Lessee has option to buy asset at the end of period with price that has been arranged in leasing agreement. 2. All the installment payment by lessee plus residual value including recovery cost of the least capital expenditure along with the interest is treated as lessor's gain 3. Minimum lease term is 2 years	Requirement for period of finance lease by PSAK 30 (1994): minimum 2 years, but PSAK 30 (2011): the lease term is for the major part of the economic life of the asset PSAK 30 (1994) shows bright lines that the lease term is 2 years. PSAK 30 (2011) requires the major part of economic life of the asset, without clear limitations.

The difference between rules-based and principles-based standards affects the financial reports. This can be seen from the classification of lease as finance lease or operating lease, and their influences on the record of the lessee. At the recognition of an operating lease, lessee does not recognize rent expense as any long-term liability for future rental payment on the statement of financial position. Lessee reports rent expense on the income statement. While in finance lease, the lessee recognizes long-term assets and liabilities. Therefore, lessee will record the depreciation of asset lease and recognised interest payable as long-term liability in lease.

Hence, the following differences occur if using a finance lease instead of an operating lease: (1) an increase in the amount of reported debt (both short-term and long-term) (2) an increase in the total assets on the financial position, and (3) lower income early in the life of lease and, therefore, lower retained earnings. Thus, many companies believe that finance lease negatively impact their financial position because their debt to total equity ratio increase and the rate of return to the total assets decrease (Kieso et al, 2011). Therefore, the company attempts to pay the lease in time (to avoid overdue of the lease payment), to have it admitted as operating lease. In addition, since finance lease can lower rates of return and increase debt to equity relationship, the amount of earnings of a company is lower, making the company less attractive to present for potential investors.

The convergence of IFRS into PSAK requires using more principles-based standard and professional judgment. PSAK 30 (1994) that adopted Indonesian Accounting Principles displays bright lines that the lease term is 2 years.

Consequently, companies attempt to pay the lease in less than 2 years to avoid overdue of the lease payment to have it admitted as operating lease. In this situation, one of the impacts for financial statement position is the increase in return on assets because of the smaller value of total assets recognized as a result of the absence of leased asset in the balance sheet. In finance lease, lessee will recognized rent expense larger in the early years of rent and decreasing in the following years. Meanwhile, recognition of operating lease will result in the same rent expense in every year, reducing profit or loss fluctuations in the income statement.

Principles-based standards do not contain specific rules but emphasizes professional judgment. Principle-based standards provide manager to choose the accounting method that can reflect substantially more real transactions or economic event. Schipper in Bangun (2012) argued that the lack of specification in a standard could cause an increase in the volatility of accounting numbers that is reported in a financial statement. Principles-based can cause inconsistent assessment so give more opportunity to do earnings management. Hence principle-based also possible to do earnings management.

2.1.6 Fair Value

According to IFRS 3 paragraph 9, the definition of fair value is

> "The price that would be received to sell an asset or transfer a liability in an orderly transaction between market participant at the measurement date".

The standard states that the best evidence of fair value will be provided by comparable transactions in similar properties in a similar location and condition. However, the standard allows the fair value to be estimated by using other information when market values are not available. The other information that an entity may draw on include (IAS 40, paragraph 46): "(i) transactions in an active market for dissimilar property (e.g. property of a different nature, condition or location, or subject to a different type of lease), as adjusted to reflect the differences, (ii) transactions in less active markets if they have been adjusted to take account of subsequent changes in economic conditions, or (iii) discounted cash flow projections based on estimated future cash flows (as long as these are reliable). Existing leases should support these and current market rents for similar properties in the same location and condition. The discount rate should reflect current market assessments of the uncertainty and timing of the cash flows." (Ernst & Young 2011).

The example of IFRS adoption done in Indonesia about more fair value is the implementation of IAS 40 about investment property by revising PSAK 13 (2011). PSAK 13 (1994) made by Indonesia Accounting Principle (PAI) has been revised into PSAK 13 (2007) and again into PSAK 13 (2011). According to IAS 40, Investment Property applies to the accounting for property (land and/or buildings) held to earn rentals or for capital appreciation (or both). PSAK 13 (1994) applied in Indonesia used the cost model for investment property. The cost model is similar to the model in the accounting standard for fixed assets (PSAK No. 16 about Fixed Assets). In PSAK 13 2007 (after IFRS adoption), investment properties are initially measured at cost with some exceptions, being subsequently measured using either a cost model or a fair value model and changes in the fair value under the fair value model is recognized in profit or loss.

After PSAK 13 (2007), PSAK 13 has been revised again in 2011 and has been effective since 1 January 2012. The difference between PSAK 13 (2007) and PSAK 13 (2011) can be seen in the table below:

Table 2.3

The Comparison of Accounting Standards for Property Investment

In PSAK 13 (2007) and PSAK 13 (2011)

The Difference	PSAK 13 (2011)	PSAK 13 (2007)
Definition	Does not regulate the definition for the ceasing of recognition	Regulate the definition for the ceasing of recognition
Preliminary recognition of investment property in construction process and development	Recognized as investment property	Recognized as fixed asset and the treatment is based on PSAK 16: Fixed asset until investment property is built completely.
Inability to set fair value	If the entity prefers to using fair value, the investment property in the process of construction process and development: -Measured based on the acquisition price until the fair value can be reliably determined or until the construction process and building are completely done (whichever comes first) -The preliminary recognition can be measured from the fair value if determined reliably	unregulated

Based on Table 2.3, since 1 January 2012, PSAK 13 (2011) replaced PSAK 13 (2007) about recognition, measurement and disclosure of property investment. There are some changes in PSAK 13 (2011) compared to PSAK 13 (2007), namely:

1. Definition in restrain of recognition

   There is a definition in PSAK 13 (2007) that regulates the ceasing of recognition, namely when the asset no longer has a future economic value and withdraw from use because the change of the function (reclassification). Meanwhile, the revised PSAK 13 (2011) does not define the ceasing of recognition because it has been described in paragraph 70 about the release of property investment.

2. Recognition of investment property in construction process and development

   In PSAK 13 (2007), recognition of property investment in construction process and development should be recognized as fixed asset and treatment is based on PSAK 16: Fixed Assets until investment property is built completely and classified as property investment. Meanwhile, PSAK 13 (2011) recognition of property investment in the construction process and development is directly classified as property investment.

3. Inability to set fair value

   PSAK 13 (2007) did not regulate the treatment about the inability to set fair value whereas PSAK 13 (2011) regulates it. This condition causes difference in earnings quality. Based on PSAK 13 (2011), the entity that is incapable to set fair value can measure based on the acquisition price until fair value can be reliably determined or until the construction process and building are completely done (whichever comes first). The preliminary recognition can be measured from the fair value if determined reliably. Reliable fair value can increase the earnings quality. If the fair value can't be reliably estimated but is still used, manager may manipulate the estimation of fair value. In this situation, the earnings quality will be lower.

According to PSAK 13 (2011) par 29, after preliminary recognition, there are two methods that can be selected to record property investment, namely:

1. Fair value model

According to PSAK No. 13, fair value of property investments is a price which property can be interchanged between the parties who have adequate knowledge in fair transaction. The fair value of property investment does not reflect capital spending in the future that will be used to increase capacity or repair the property and does not reflect the benefits of future expenditure. When the right over a property is recognized as operation lease, the fair value must be applied. Based on PSAK 13 par 37, the journal to recognize profit or loss that arises from the changes of fair value is as follows:

- If the value of investment property increases

  Dr Investment property

  Cr Gain on Investment property

- If the value of investment property decreases

Dr Loss on Investment property

Cr Investment Property

The use of fair value could provide information that is more relevant in the decision-making process. Revaluations of an asset cause the value of an asset to increase or decrease. The difference that arises from increasing the value of asset will be recognizes as a surplus of revaluation and a gain for the company. While the differences that arise in decreasing the value will be recognized as loss and can reduce the profit of the company.

Best guidelines of fair value refer at a price in the active market for a similar property in the same location and condition and also based on other leasing contracts. If the price in the active market is not available in the market, then information from other various sources should be considered, including:

A.) Current price in active market for the property that has the same condition and different locations adjusted to reflect these differences.

B.) The last price of the property in the less active market, with adjustments to give information that there has been a change in economic conditions since the transaction of the acquisition date.

C.) Discounted cash flow analysis projections based on estimated future cash flows (as long as these are reliable).

There are different conclusions in some cases about the fair value of property investment. Entities should consider the reasons upon these differences to obtain an estimation of the fair value from the most reliable in the range of estimates of the appropriate fair value. In certain cases, there is the possibility that fair value of property investment cannot be determined reliably. This could happen if similar transactions are rare and projection of cash flow is not available. In the case the property investment cannot use a reliable fair value, the cost model must be applied until the property is released. The property investment measured using fair value should not be depreciated. An entity always presents the fair value at the end of the period of financial reporting so depreciation will not influence the value that is presented in the financial report.

One of the weaknesses of using fair value is the difficulty for determining the fair value of assets or liability that has no active market value. As the consequence, the appraisal tends to be subjective because there is no specific standard for assessment. Thus, more fair value in the adoption of IFRS into PSAK can cause differences in earnings quality between before and after the adoption of IFRS.

2. Cost Model

Investment property that uses cost method records at acquisition cost minus accumulated depreciation. Cost model is more refers to PSAK No. 16 about Fixed Assets. The application of cost model implies the possibility of declining value (as regulated in PSAK no. 48 about the decline in value).

2.1.7 Real Estate, Property and Building Construction Companies

Property and real estate industries are generally two different industries. Real estate covers the land and all permanent development on it, including the buildings, such road development, open space and any other kind of permanent developments. According to the Indonesian government rule, the definition of real estate industry is included in PDMN No. 5 1974 which regulates real estate industry. The definition of real estate industry in this rule is a property company running in availability and supply for land for industries, including tourism industry. While the definition of property based on SK Menteri Perumahan Rakyat no.05/KPTS/BKP4N/1995, Ps 1.a:4 is the righted land and/or permanent buildings which become the owner's objects and development. In other words, property is a real estate industry with the addition of regulation such as lease and ownership.

Various products are developed by property and real estate industries. Those products might be in the forms of housing, apartment, home store, buildings for offices, and trade centers such as mall or plaza. Housing, apartment, home store, home office, and buildings for offices are included into landed properties while trade centers like mall and plaza are included into commercial buildings.

2.1.8 Earnings Quality

Earnings quality is a measurement of how well earnings reflect the actual performance of a firm (Dechow and Schrand, 2004). Earnings quality is low if earnings presented not in accordance with real earnings and vice versa. One of assessment to determine earnings quality is through earnings management. Earnings management is the act of intentionally influencing the process of financial reporting to obtain some private gain. Earnings management can make bias in financial report. Therefore, earnings management clearly related to earnings quality because earnings management decreases earnings quality (Dechow and Schrand, 2004).

Many of the existing studies refer to Jones (1991) model as a basis for assessment of the level of earnings management through accrual. Accrual consist of nondiscretionary accrual and discretionary accrual. Nondiscretionary accrual is mandatory expense/asset that has been recorded within the accounting system that has yet to be realized. Examples of nondiscretionary accrual are next month salary and next any upcoming bill. Meanwhile, discretionary accrual is a non-mandatory expense/asset that has been recorded within the accounting system that has yet to be realized. An example of this would be management bonus. The main idea in the Jones (1991) model is that discretionary accruals are likely to be the result of managerial discretion. In the Jones (1991) model, the concept of discretionary accruals is used to indicate the quality of earnings. Smaller discretionary accruals has higher earnings quality.

2.1.9 Earnings Quality Measures

According to Kamaruddin et al., (2014), earnings quality has certain characteristics such as persistence or sustainability, predictive ability, smoothness, conservatism, value-relevance, timeliness, earnings management or earnings manipulation and accrual quality. In general, earnings viewed as being of high quality are those that have a high level of persistence, are more predictable, less volatile, timelier, have lower level of earnings management and/or higher accrual quality. The following subsections discuss each of the measures, which have frequently been used in prior studies.

1. Earnings Management

   Many of the existing studies refer to Jones (1991) model as a basis for assessment of the level of earnings management. In the Jones (1991) model, the concept of discretionary accruals is used to indicate the quality of earnings. The main idea in the Jones (1991) model is that accruals are likely to be the result of managerial discretion and changes in the firm's economic environment (Hermanns, 2006). Basically, the model estimates firms' abnormal accruals (discretionary) based on certain economic and accounting fundamentals using time-series regression. In the model, Jones relates total accruals to the change in sales and the level of gross property, plant and equipment. The residuals of the model are considered as abnormal or discretionary as they are not explained by the firm's economic conditions.

2. Accrual Quality

   Earnings quality based on the notion that the function of accruals is to adjust the recognition of cash flows over time, so that it reflects better firm performance.

3. Earning Persistence

Earnings are considered to be of high quality when they are sustainable.

4. Earning Predictability

   A measure of earnings quality based on the assessment of the ability of earnings to predict future cash flows. Earnings predictability is a similar construct to earnings persistence as both relate to the time-series behavior of earnings.

5. Value Relevance

   Earnings quality is measured by its value-relevance to investors in relation to equity valuation. The association between earnings and stock market performance suggests that earnings are both relevant and reliable to investors.

6. Timeliness

   According to Abdullah (2006), timelier reporting is associated with higher accounting quality, as users are able to use the information for such purpose as valuation and evaluation. More timely information (including earnings) is more relevant and thus more useful for financial statements users. Based on this idea, a number of studies use timeliness as one of the qualities of desirable earnings.

Earnings quality measurement for this research uses the proxy of abnormal accruals. The review of the proxies of earnings quality conducted by Dechow et al. (2010) indicate that the most common measure of earnings quality researched is abnormal accruals. According to Simarmata (2015), before measuring 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 distinguish “abnormal” from “normal” accruals by directly modeling the accrual process. The normal (nondiscretionary) accruals are meant to capture adjustments that reflect fundamental performance, while 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 (Simarmata, 2015).

2.2 Previous Research

Several researches have been done concerning the effect of IFRS adoption. The research done by Muhammad and Tony (2010) examined the effect of IFRS adoption and investor protection on warnings quality around the World. The result was that earning quality increases mandatory IFRS adoption when a country’s investor protection regime provides stronger protection. The result highlighted the importance of investor protection for financial reporting quality and the need for regulators to design mechanisms that limit managers to do earnings management. Daniel, Sonda and Yosra (2012) examined the effect of mandatory adoption of IFRS on earnings quality: evidence from the European Union. The study found some improvement in accounting quality between the pre- and post-IFRS adoption periods. They also found that firms exhibit an increase in the accounting-based attributes, but a decrease in the market-based after the adoption of IFRS in 2005.

Ismail and Kamarudin (2013) examined earnings quality and the adoption of IFRS-based accounting standards in Malaysia. The results show 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 relevant.

Lyu, Yuen and Zhang (2014) examined IFRS adoption and real activities manipulation. The result is that real earnings management is driven by abnormal production costs, and that more companies manipulate earnings through operational transactions after IFRS adoption. Real activity manipulation is positively related with IFRS implementation, and that such an association is stronger for real estate firms, especially in the case of abnormal cash flows of operations. Barth et al. (2008) found that IFRS adoption increases earnings quality, in terms of comparability and earnings management. Also, Sun et al. (2011) argued that there is a relationship between IFRS and high earnings quality. Moreover, Ewert and Wagenhoffer (2005) found that tightening accounting standards reduces earnings management and leads to higher reporting quality. Ball et al. (2003) found that the IFRS adoption in firms in East Asia did not bring any changes in the financial reporting quality. This happen because some investors believe that the cost to implement IFRS is greater than the benefit achieved, thus investors react negatively to the market by selling the shares they own and caused a decrease in stock price of the firms, and cause a negative abnormal return.

2.3 Hypothesis Development

In 2008, Indonesia started to adopt IFRS into PSAK. The convergence of

IFRS into PSAK causes difference like the change from rules-based into principles-based standards. Rules-based is consistent because there is clear standard and quantitative standard. In other side, Principle-based standards provide manager to choose the accounting method that can reflect substantially more real transactions or economic event. This argument suggests that using principles-based standards will improve the relevance and usefulness of financial reporting information (Herz in Folsom, 2012). Because of that, it will indicate that earnings quality of the company will increase. Principles-based standards require more professional judgment, it makes the standard become flexible and subjective in assessing assets or liabilities. However, earnings management occurs when managers intentionally conduct bad judgment.

The adoption of IFRS requires PSAK to use more fair value. The advantage of using fair value is that fair value accounting reports assets and liabilities on the basis of their actual or estimated fair market prices. In other words fair value reflects true economic situation. The examples of fair value are PSAK 16(2011) and PSAK 13(2011). According to PSAK 16(2011) and PSAK 13(2012), increases or decreases in earnings that arise from the revaluation of assets (PSAK 16) and the revaluation from investment property (PSAK 13) have to be debited or credited to net income. Thus, the fair value recognition gives impact to earnings. On the other hand, fair value also has weaknesses. One of the weaknesses is the difficulty for determining the fair value of assets or liability which has no active market value. As a consequence, the appraisal tends to be subjective because there is no standard for assessment. PSAK 13 revised 2011 for the regulation of investment properties in the process of construction and development forces the company to use reliable fair value. If the fair value is not reliable, companies should directly use acquisition price. If the manager still uses fair value that is not reliable, it will give oppurtunity to the manager to manipulate earnings through changes in fair value. Consequently, the use of fair value in the adoption of IFRS into PSAK could cause differences in earnings quality between before and after the adoption of IFRS.

Based on the previous explanation about the changes in PSAK after IFRS adoption, it can be seen that the adoption of IFRS can increase or decrease earnings quality. Similar previous research was conducted by Ismail and Kamarudin (2013) that examined earnings quality and the adoption of IFRS-based accounting standards in Malaysia. The results show 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. However, research done by Handayani (2014) found that the adoption of IFRS would not affect accruals and real activity earnings management of manufacturing companies in Indonesia. The increase or decrease of earnings management causes the difference in earnings quality of companies. Based on these ideas and previous research, the following hypothesis can be formulated:

Ha : There is significant difference in earnings quality between before and after IFRS adoption