

CHAPTER I

INTRODUCTION

1.1 Background

Currently, International Financial Reporting Standards (IFRS) convergence process which officially started in 2008 has entered the second phase to completely implement IFRS to Indonesian Generally Accepted Accounting Principles called *Pernyataan Standar Akuntansi Keuangan* (PSAK), which will take place from 2013 to 2015. The convergence process is done as the commitment of Indonesia in the G-20 agreement. The results of G-20 meeting in Washington DC on November 15, 2008 that was declared as follows: (1) Strengthening Transparency and Accountability; (2) Enhancing Sound Regulation; (3) Promoting Integrity in Financial Markets; (4) Reinforcing International Cooperation; and (5) Reforming International Financial Institutions (Zamzami, 2011).

For the reporting entity, the most important point of G-20 agreement is to strengthening transparency and accountability. IFRS are principle-based accounting standards that are designed to cover the weaknesses of the old accounting standards, such as the recording of off-balance sheet or the use of extraordinary items. Besides, it is also expected to enhance global comparability of financial information which are derived from countries. Hence, IFRS have high levels of implementation which is much broader and include practices in various entities; since the principle is much more fundamental and flexible when compared with the rule-based standards that are more detailed and inflexible. Thus, it enables

the use of professional judgment making financial statements to give better reflection on the substance of transaction and economic conditions. Since the judgment may contains various perspective, it is quite important in determining the professional judgment with the basis of logical reasoning and reasonable.

Back in 2004, the International Accounting Standard Board (IASB) revised International Accounting Standard (IAS) 36 - Impairment of assets, IAS 38 – Intangible assets and introduced International Financial Reporting Standards (IFRS) 3 – Business Combinations. This standards altered the Indonesian accounting standards for PSAK 48 (Revision 2009) – Impairment of assets, PSAK 19 – Intangible assets and PSAK 22 (2010) – Business Combination. These will be the basis form to the accounting procedure goodwill in Indonesia. Therefore, listed companies in Indonesia are required to use PSAK 48 (Revision 2009), PSAK 19 and PSAK 22 (2010) to recognize and evaluate goodwill.

In the new adjustment of PSAK 22 (2010), goodwill is no longer amortized but is subject to an annual impairment test. The purpose of the new standard IAS 36 is to prohibit the method of goodwill amortization that leads to arbitrary accounting (IFRS 2008, BC 140). By using the impairment method, it is possible for a company's management to process several assumptions in the impairment test. It is therefore interesting to examine whether this treatment leads to better accounting of goodwill, based on relevance and timeliness of accounting information.

PSAK 22 (2010) stipulates that the company should record a loss due to impairment if the recoverable amount is smaller than the carrying amount. The amount of the impairment loss can be determined by performing an impairment test

every year. According to the standards, then the amortization expense is not reported in the financial statements. Impairment test is considered in giving better reflection of the transaction' substance and the economic condition so that the information presented not mislead the users of financial statements in making decisions. Therefore, goodwill does not necessarily decline in value on a routine basis but rather has an indeterminate life; led to the conclusion in PSAK 22 (2010) that goodwill should not be amortized but instead must be tested at least annually for impairment.

The impairment for goodwill is set in PSAK 48 (Revision 2009) in accordance with IAS 36 – Impairment of assets. Specifically, PSAK 48 (Revision 2009) is designed to ensure that assets are carried at no more than their recoverable amount and to define how the recoverable amount is calculated. The steps to do impairment test needs high degree of management estimation especially when determining the Cash Generating Unit (CGU) allocated to goodwill, amount of goodwill allocated and the amount of recoverable amount. Recoverable amount is used as a comparison between fair value less cost to sell or value in use. The difficulty in determining the fair value of CGU as a goodwill allocation makes the management typically uses the value in use to determine the recoverable amount of the CGU.

Determination of the recoverable amount will depend on management's estimation. If the recoverable amount of goodwill is less than the carrying amount, the carrying amount of the goodwill is reduced by the recoverable amount. Impairment losses will be reported as an expense in the income statement and will reduce the amount of goodwill reported in the statement of financial position;

impairment of goodwill cannot be recovered. PSAK 48 (Revision 2009) seems to give management flexibility to exercise their judgment in determining and reporting goodwill impairment losses – which is very subjective. The determination of amount in impairment test that require management's estimation may become the accounting choice for management. This accounting choice of writing down the value of goodwill and the magnitude of impairment loss provides a good chance for managers to opportunistically manage the reported earnings.

1.2 Research Question

The adoption of IAS 36 through PSAK 48 for Impairment of Assets produce some changes in the treatment of goodwill in Indonesia. The previous standard needs to amortize the goodwill but now it becomes the subject of impairment test. The steps to do impairment test is very subjective and depending to the managements' estimation which need professional judgment. This judgment will be used to set the cash generating unit when impairment test is done. The flexibility of the managements to record goodwill impairment loss and to written-off the goodwill regarding their own estimation will raise high possibility of earnings management.

Based on Alves (2013), she investigates whether Portuguese listed companies use goodwill impairment loss to manage earnings. Using a sample of 33 Euro next Lisbon non-financial firms over a period of 6 years, from 2005 through 2010, she found that goodwill impairment is significantly positive related to earnings management using discretionary accruals as the measurement to detect it. It

supports the idea that IAS 36 provides managers with discretion for goodwill write-off. Moreover, the results also reveal that there is less earnings management when the board size is large and when cash flows are high and that there is more earnings management when leverage and political costs are high.

In Indonesia, researches regarding goodwill impairment and earnings management has been done through Dewi K (2014) and Walangitan (2011) using Return On Assets and Return On Sales as the measurement. There is still no research using discretionary accruals as the proxy to detect earnings management. Based on Laili et al. (2014) measurement tools such as Jones (1991) model, a modified Jones model used In Dechow et al. (1995), or regression analysis will provide more solid evidence about utilizing goodwill impairment for earning management. Moreover, goodwill impairment is using high level of management discretions.

This research will replicate Alves (2013) which will investigates whether listed companies in Indonesia use goodwill impairment to manage earnings using discretionary accruals as the measurement with board size, leverage, political cost, and operating cash flow as the control variables. This control variables are taken from Alves (2013) as the consideration that goodwill impairment is not the sole factor which affecting earnings management.

Based on the explanation, thereby, this research will raise questions:

Does goodwill impairment positively affect earnings management measured using discretionary accruals?

1.3 Research Objectives

This research has an objective to prove that empirically goodwill impairment positively affects earnings management measured using discretionary accruals.

1.4 Research Contributions

This research will make contribution to:

1) The Regulator/standard setters

The regulator/the standard setters need to know which standards and which accruals are being used to manage earnings. This research will give evidence to show the flaws of the standards. This information will highlight the areas which need corrective action or revision by the standard setters.

2) Investors and practitioners

The findings of this study can be the new interest of investors and practitioners which are concerned about improving the quality of financial reporting and earnings management to make decision and further analysis.

3) Management

The management decision whether to impair the goodwill or not, could be an important point (event) to the company's performance and market value. Therefore, by studying this issue will considerate the management while giving and deciding their judgment to the discretion in recognizing goodwill asset impairment losses will be important.

1.5 Writing structures

This research has writing structures as follow:

CHAPTER I INTRODUCTION

This chapter will contain the background, problem, objectives, and the contribution of this research. It also gives the brief explanation of data analysis and the writing structures.

CHAPTER II LITERATURE REVIEWS AND HYPOTHESES DEVELOPMENT

This chapter will elaborate the theoretical background about goodwill impairment and earnings management. It also contains previous researches which support the research. These will be used as a basis in formulating hypotheses development.

CHAPTER III RESEARCH METHODOLOGY

This chapter includes research design such as data collection, sample, definition and measurement of variables. It is followed by the elaboration of technique and steps to test the data and hypotheses.

CHAPTER IV DATA ANALYSIS AND DISCUSSION

In this chapter, the result of the tests will be presented and analyzed to find the conclusion about goodwill impairment and the earnings management.

CHAPTER V

CONCLUSION

This chapter will describe the conclusion and limitations of the research, along with the suggestion for the next research.

