

CHAPTER I

INTRODUCTION

1.1. Research Background

Financial statement is the main source of information for investors to analyze the financial condition of a company. Based on agency theory, investors act as principal who provide economic sources for company. Unlike management who act as agent, principal do not have complete information about company activity and performance. This information is important, that can give deeper understanding to make decisions, especially investment decision. Hence, management have obligation to present this information to investors. Management presents this information to investors in form of financial statement.

According to IASC (International Accounting Standard Committee) Framework, financial statements aim to provide information that can be used by investors to make economic decision. Financial statements prepared to meet general needs of all users. Although only financial information provided in financial statement, most users rely primarily on financial statements to find information that useful to make decisions. For instance, investors assess financial statement to decide whether to buy, held, or sell company's shares.

In order to be useful to make economic decisions, information in financial statement need to have certain qualification. IASC's qualitative characteristics of financial statements existence in information is a must. The

first one is understandability, where users can understand the information provided in financial statements. The second is relevance, where information can help the users evaluate the past, present or future events. The third is reliability, where the information should be free from error and bias and represent the true condition of company. The last one is comparability, where users can easily compare the information from one period with other period or from one company with other company.

IASC Framework provides deeper understanding on one of four qualitative characteristics of financial statements, which is reliability. In order to meet reliability qualification, information should have five attributes: faithful representation, substance over form, neutrality, prudence and completeness. Management face many uncertainty in certain company activity, such as set the allowance for doubtful receivable accounts and provision or decide the useful life of capital assets. While dealing with uncertainty, prudence is used by accountant to make correct judgment. Prudence is the need of more careful or caution judgment in making estimation about uncertainty.

One of components in financial statement is earnings. Earnings can be considered as the most important information in financial statement to make investment decision. From earnings number, investors do not only get the insight about company performance but also its ability to pay dividend. A company needs to have sustainable growing earnings to attract investors. Sustainable and growing earnings mean the company will be profitable in the

future and able to continuously pay dividend, while company with small and unsustainable earnings may be less profitable in the future. The latter tend to be less attractive in investors' point of view. Hence, management will carefully present earnings and try to make earnings more appealing.

Appealing earnings, however, does not always show good earnings quality. Many practices can be used by management to provide appealing earnings. Most of them, although not all, can reduce the quality of information present in financial statement. Earnings information could be manipulated due to the advantage held by manager over investor. Manager has more information about company's condition compared to investor as an outside party who does not involve in company activity. This information asymmetry will give opportunity to manager to perform earnings manipulation. Hence, appealing earnings reported by manager have high possibility to be manipulated.

Francis et al. (2006) stated that good earnings quality is earnings information that precisely reflect the real condition of company and contain less uncertainty. As mentioned earlier, good earnings number or appealing earnings does not always same with good earnings quality. Earnings information that reflects the real condition of company can show bad earnings number and poor company's performance. On the other hand, high earnings number resulted from manipulation practices by manager show poor earnings quality, as it does not reflect the real condition of the company.

Criteria for good earnings quality also mention in Dechow et al. (2010) and Schipper and Vincent (2003), as they defined earnings quality as the quality that earnings should have to make it useful for decision making. If earnings cannot provide information that can be used to make decision, then it can be said as poor earnings quality. Srinidhi et al. (2011), Bellovary et al. (2005), and Li (2011) stated that good earnings quality means that current period earnings can be used as benchmark to predict future earnings. In other words, earnings information will not significantly change from time to time. Hence, we can say good earnings quality can be achieve if the information useful to make decision, which is to predict the future earnings.

This study follows the view that good earnings quality is earnings information which contains no manipulation practice. The act of earnings manipulation by managers or earning management will result in misleading information. This type of information will not be able to fulfill the objective of financial statement which is provides information that assist its user to make decision. To limit the practice of earnings management, company can use prudence or conservatism. Conservatism is one principle that able to reduce manager's opportunity to do earnings management. Eventually, it will lead to the achievement of good earnings quality.

Prudence as mention earlier, it is one component of qualitative characteristic that require higher degree of caution in presenting information when uncertainty occur. Conservatism also can be means as the action to choose decision that will less not overstating income and assets when dealing

with uncertainty condition. Conservatism from Kimmel et al. (1998) and Marshal et al. (2002) point view is the principle used by accountant to make judgment and estimates that will result in lower profits and asset valuation estimates. Conservatism principle contradicts with earnings management as it does not allowed manager to overstate earnings number to get certain amount of bonus or incentives. Hence, conservatism practice in the company can reduce the level of earnings management.

This study supports the view of conservatism role in reducing earnings management practice. The low level of earnings management results in higher earnings quality, as earnings information reflect company's real condition. Previous studies result shows that applying conservatism result in lower earnings management level. As mention by Watts (2003), LaFond and Watts (2008), and Haniati and Fitriany (2010) conservatism reduce the manipulation practices by management as its limit manager's opportunity to overstate assets and earnings number. Moreover, conservatism principle also requires manager to use higher degree of caution when dealing with uncertainty. Hence, it can be said that conservatism lead to more precise presentation of earnings information and less uncertainty earnings information which mean good earnings quality.

Although many studies and literature mention about positive impact of conservatism, other studies found bad impact of conservatism. In Indonesia, many studies attempt to find the impact of conservatism practices to company and investors, such as Widya (2004), Haniati and Fitriany (2010), Oktomegah

(2012) and Sari (2014). The result are varies and sometimes contradict one another. Some of researchers find positive impact and some other find the opposite. Nevertheless, it still becomes one topic that attracts researchers in Indonesia and other countries around the world due to its controversial relation with accounting standard setter and its diverse result in previous studies. Moreover, Widya (2004) found more than 50% companies in Indonesia are proven apply conservatism. This study will help investor to get deeper insight on the impact of their choice to implement conservatism principle. Hence, this study is worthy to be done and its result can give idea about conservatism to investor, company, and standard setter.

1.2. Research Problem

Earnings as the most wanted information in financial statement need to have good quality of information to make it useful for decision making. As the cost to present appealing and good earnings quality sometimes unbearable to be paid by certain companies, management will try to practices accounting method to achieve it. It can be resulted in good earnings quality as expected. On the opposite, certain practices could jeopardize the quality of earnings presented in financial statement.

Previous research show different impact of conservatism on earnings quality. The result of their studies are varies, depend on their interpretation of earnings quality. Some suggest conservatism reduce manipulation practices by management which represent good earnings quality. Some suggest

conservatism reduce sustainability of earnings and its ability to predict future performance which represent poor quality of earnings.

Many studies in Indonesia have been done for more than one decade to find the impact of conservatism practices. Conservatism has been widely used by Indonesian company. The result of their studies also contradicts one another. Some suggest positive impact of conservatism practices, especially related to how investors value company which applied conservatism. Some suggest conservatism give negative impact for company. However, none of the studies show the impact of conservatism to earnings quality.

From different findings related to conservatism impact on earnings quality and the absent of studies in Indonesia related to the topic, this study raises a question:

Does conservatism give impact to earnings quality of listed companies in Indonesia?

1.3. Research Objective

This study will provide the answer along with empirical evidence whether conservatism gives impact to earnings quality of listed companies in Indonesia.

1.4. Research Contributions

a. For Investors

Financial statement as the main information used by investors to make economic decision should fulfill qualitative characteristic that make it useful. The demand of useful information is raised as certain investors depend only on financial statement to assess company's financial condition. This study will help investors to make judgment about the quality of financial statement. Through this study they will get deeper understanding whether certain accounting practices affect the quality of earnings information they used to make economic decision.

b. For Standard Setter

Previous studies show different result about the effect of conservatism implementation in company. Some researcher found positive impact of conservatism to the information reported in financial statement, others found conservatism the negative impact which is reduce the quality of information reported. The difference result of conservatism implementation made it become debatable issue. From this research, standard setter will obtain deeper information about the impact of regulation made by them regarding conservatism implementation. It will help standard setter to improve the regulation regarding conservatism, as conservatism still become controversial issue in accounting fieldwork.

c. For Academic

This study will broader the knowledge about conservatism. As conservatism still becomes one controversial issue, this study may give answer to certain questions raise related to conservatism impact on

earnings quality. In the future, this study can also become trigger for development of research related to conservatism.

d. For Readers

As limited number of research exist in conservatism issue in Indonesia, this study will give additional knowledge that will deepen the understanding of the reader related to impact of conservatism to earnings quality of listed companies in Indonesia.

