

THE IMPACT OF CONSERVATISM TO EARNINGS QUALITY OF LISTED MANUFACTURING COMPANY IN INDONESIA

**Melisa Stefani
Dewi Ratnaningsih**

**International Financial Accounting Program, Faculty of Economics,
Universitas Atma Jaya Yogyakarta
Jalan Babarsari 43-44, Yogyakarta**

ABSTRACT

This study aimed to investigate the impact of conservatism to the quality of earnings information. Conservatism is one of accounting topic that become an important issue, as its impact to accounting fieldwork can be positive and negative. While earnings information is crucial information needed for the users to make economic decision. Samples in this study are listed manufacturing companies in Indonesia. Conservatism is the independent variable. Earnings quality as dependent variable will be represented by earnings management.

The result of this study show positive impact of conservatism to earnings quality. Conservatism is proven to increase earnings quality by decreasing the level of earnings management in the company. The result of this study complement previous studies findings.

Key words: Conservatism; Earnings Quality; Earnings Management; Market to Book Value; Discretionary Accruals

I. Introduction

A. Background

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 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 compare to investor as 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 mention 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.

B. Research Problem

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

C. Research Objective

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

II. Theoretical Background and Hypothesis Development

Earnings quality is the quality of earnings information reported in financial statement. Good earnings quality should be able to help users in assessing company's financial condition. In order to be useful in helping users to make economic decision, information should be presented faithfully and contain no error and bias. In addition, earnings information should be precise or contain less uncertainty.

In reality, good earnings quality sometimes does not pleased investors. This is due to the actual earnings number appeared low or negative in financial statements as company face bad economic condition. When managers deal with such condition, it is hard to achieve appealing earnings number. Hence, they will try to manipulate earnings number to pleased investors. This manipulation practices are widely known in accounting fieldwork as earnings management.

In company's life cycle, uncertainty conditions are difficult to avoid. It gives management room to choose different accounting method and policies. As often happens, opportunistic managers may choose different accounting method and policies to obtain personal goals. Their action will eventually lead to earnings manipulation practices or known as earnings management. Since earnings management result in bias and less precise earnings information, earnings management practice decrease earnings quality.

In order to reduce the opportunistic behavior of managers in uncertainty condition, accounting standards propose conservatism principle. Under conservatism principle, managers are required to have higher degree of caution in dealing with uncertainty situation. It also requires managers to choose accounting method and policies that will not overstate income and assets. Hence, managers have limited accounting method and policies to choose in order to fully implement conservatism.

Watts study entitled "Conservatism in Accounting" (2003) mentioned that conservatism asymmetric verification limits incentives and opportunity of manager to give bias and noise information. In other word, conservatism limits manager opportunity in practicing earnings management. This bias and noise information decrease earnings quality, as good earnings quality should faithfully represent company's real condition and contain no bias and error. Watts suggest that conservatism decrease earnings management and eventually lead to higher earnings quality.

Supporting Watts (2003) study, Lafond and Watts (2008), Lara et al. (2012), and Haniati and Fitriany (2010) also found conservatism implementation decrease earnings management. Due to its requirement to not overstated assets and earnings, managers attempt to perform earnings management that lead to higher earnings number is decreased. This study attempts to find the same result as previous studies, which is conservatism lead to good earnings quality. The way conservatism increase earnings quality is with decreasing management opportunity in practicing earnings management. These arguments lead to the following hypothesis:

H1: Conservatism increase earnings quality of listed companies in Indonesia.

III. Research Methodology

1. Population and Research Samples

This study use all Indonesia listed manufacturing companies from year 2010 until 2014 as population. The periods are chosen to show the latest condition related to conservatism implementation in Indonesia listed companies. The selection of manufacturing company as population is due to previous studies findings, such as Trisnawati et al. (2012) and Sari

(2014), that accrual model used as proxy for earnings management is proven to be more suitable for manufacturing companies in Indonesia. This study use purposive sampling in order to obtain suitable sample based on criteria.

2. Data Collection Method

This study use secondary data collection method. The data will be collected from existing database of listed company financial statements and stock price. From the database, this study will download complete financial statements that consist of statement of comprehensive income, statement of financial statement, statement of changes in owners' equity and statement of cash flow. For stock price data, this study use information from Yahoo Finance website.

3. Operational Definition and Measurement of Research Variables

a. Independent Variable

This study will measure conservatism using the measurement developed by Beaver and Ryan (2000). They use market to book value ratio to measure conservatism. This proxy has been proven to be used as conservatism measurement by fellow researcher Watts (2003). The proxy for conservatism is

$$CONACC_{i,t} = \frac{(Number\ of\ shares_{i,t} \times Shares\ price_{i,t})}{Total\ equity_{i,t}}$$

Where,

$CONACC_{i,t}$ = the level of conservatism

$Number\ of\ shares_{i,t}$ = company's outstanding shares at the end of period

$Shares\ price_{i,t}$ = company's shares price at the end of period

$Total\ equity_{i,t}$ = company's total equity

This measurement is in accordance with conservatism as accounting principle that will result in lower company's book value compare to its market value. The company's book value represent by its total equity, while its market value represent by its shares market price. The value of $CONACC_{i,t}$ more than one means company implements conservatism principle, because company record book value lower than its market value.

b. Dependent Variable

This study use earnings management as proxy for earnings quality. Earnings management is deliberate action of managers to manipulate or manage earnings to provide result that will give huge benefit for them. This action will decrease the quality of information reported on financial statements, because the information contain bias that will lead to investor misinterpretation. Hence, the dependent variable in this study is earnings quality that measure by earnings management.

This study will measure earnings management using modified Jones model of abnormal accrual. This proxy has been proven to be the best measurement for accrual earnings management by Dechow et al. (1995) and Suranggane (2007). Below is regression model to find abnormal accrual, widely known as Modified Jones model:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha \frac{1}{A_{i,t-1}} + \beta_1 \left(\frac{\Delta REV_{i,t} - \Delta AR_{i,t}}{A_{i,t-1}} \right) + \beta_2 \frac{PPE_{i,t}}{A_{i,t-1}} + \varepsilon_{i,t}$$

Where

$TA_{i,t}$ = total accruals in period t

$\Delta REV_{i,t}$ = The change in revenue

$\Delta AR_{i,t}$ = the change in account receivable

$A_{i,t-1}$ = total assets in period t-1

$PPE_{i,t}$ = the sum of property, plant, and equipment

Total accruals in period t or $TA_{i,t}$ can be found by equation below

$$TA_{i,t} = NI_{i,t} - CFO_{i,t}$$

Where

$TA_{i,t}$ = total accruals in period t

$NI_{i,t}$ = net income in period t

$CFO_{i,t}$ = cash flow from operational activity in period t

Total accruals consist of two components, namely discretionary and non-discretionary accrual. The abnormal accrual is represented by discretionary accrual. Discretionary accrual in the regression model is the $\varepsilon_{i,t}$.

$$DA_{i,t} = |\varepsilon_{i,t}|$$

Where,

$DA_{i,t}$ = Discretionary accruals in period t

The expected value of error $\varepsilon_{i,t}$ is negative, hence the absolute is needed to make it positive. The higher the result of $DA_{i,t}$ means the higher earnings management practices or the lower its earnings quality. On the contrary, the lower the result means decrease earnings management or higher earnings quality.

c. Control Variables

This variable may influence dependent variable, however the level of influence is not high. Hence, this study include control variable to reduce the bias result if this variable being omitted. There are three control variables in this study.

- Leverage

The first control variable in this study is leverage. It has been prove by DeAngelo et al. (1994) and Permatasari (2005) that this variable influences the earnings management in the company. The higher the leverage ratio means the higher discretionary accruals of the company. This is due to the financial pressure of high leverage firm will lead them to do income-decreasing accruals in order to renegotiate debt covenant. This study will measure leverage using equation below:

$$LEVERAGE_{i,t} = \frac{Total Liabilities_{i,t}}{Total assets_{i,t}}$$

- Firm Size

The second control variable in this study is based on Nelson et al. (2002), Kim et al. (2003), Permatasari (2005), and Llukani (2013) study. They found firm size influence the earnings management. Both small size and big size firm use earnings management to achieve certain objective. The bigger the size of the firm means the higher abnormal accruals or discretionary accruals. This is due to the higher bargaining power held by big size firm to the auditor. The auditor will loosen the earnings management practice done by big size firm. This study will measure firm using natural logarithm of total assets

$$SIZE_{i,t} = Ln Total Assets_{i,t}$$

- Auditor

The third control variable in this study is based on Becker et al. (1998), Gore et al. (2001), and Permatasari (2005) study. They found audit firm which perform the audit process have influence to earnings management level in the company. As in the previous studies, this study will divide the audit firm into two groups. First group is audit firm which include in big four audit firms, such as Deloitte, KPMG, PwC, and EY. Second group is audit firms which not include in big four audit firms. The result of previous studies shows lower earnings management practices in big four audit firms.

$$AUDITOR_{i,t} = \text{dummy variable to identify the audit firm}$$

Where $AUDITOR_{i,t}$ is equal 1 for The Big Four audit firms and 0 for audit firms outside The Big Four.

4. Data Analysis

Based on sample criterias, there are 86 companies that can be used as samples from period 2010-2014. Hence, the total final sample for this study is 430. The samples have been check thoroughly and all variable required can be obtained.

a. Normality Test

This study will test the normality of data using Kolmogorov-Smirnov Normality Test. This test will provide information about the normality of data distribution. The criteria to make decision are shown below:

- If significance value > 0.05 , then it can be said that the data have normal distribution.
- If significance value < 0.05 , then it can be said that the data have abnormal distribution.

b. Multicollinearity Test

This study will test the relation between each independent variable. The relation between each independent variable should not be existed to fulfill regression model requirement. This study use Value Inflation Factor (VIF). The criteria to make decision are shown below:

- If $VIF < 10$ and $Tolerance > 0.1$, then it can be said there is no multicollinearity
- If $VIF > 10$ and $Tolerance < 0.1$, then it can be said there is multicollinearity

c. Heteroscedasticity Test

This study will test the distribution of residual value or error for each independent variable using Glejser Test. It regresses independent variable with its absolute residual value. To fulfill the regression model requirement, the residual value should be the same (no unequal variance) for each independent variable. The criteria to make decision are shown below:

- If significance value > 0.05 then it can be said there is no heteroscedasticity.
- If significance value < 0.05 then it can be said there is heteroscedasticity.

d. Autocorrelation Test

This study will test the correlation between residual value in one period and other period. The requirement for regression model is the absence of correlation of residual value from period to period. Durbin-Watson (DW) test will be used to find the existence of correlation. The criteria to make decision are shown below:

- If $d < dL$ or $d > 4-dL$, then it can be said there is autocorrelation
- If $dU < d < 4-dU$, then it can be said there is no autocorrelation

e. Hypothesis Test

To test the hypothesis, this study uses multiple regression model below:

$$DA_{i,t} = \alpha + \beta_1 CONACC_{i,t} + \beta_2 LEVERAGE_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 AUDITOR_{i,t} + \varepsilon_{i,t}$$

Where

$DA_{i,t}$ = the discretionary accruals

$CONACC_{i,t}$ = the level of conservatism

$LEVERAGE_{i,t}$ = the level of company leverage

$SIZE_{i,t}$ = the firm size represent by natural logarithm of total assets of the company

$AUDITOR_{i,t}$ = the dummy variable that identify audit firm which perform audit process for the company

The criteria used to make decision about the hypothesis are shown below:

- H_a accepted if P -value < 0.05 and $\beta_1 < 0$
- H_a rejected if P -value ≥ 0.05 and $\beta_1 \geq 0$

The higher the level of conservatism $CONACC_{i,t}$ will result in lower earnings management or discretionary accruals $DA_{i,t}$. The lower the discretionary accruals result in higher earnings quality, hence alternative hypothesis will be accepted if there is negative relationship between $DA_{i,t}$ and $CONACC_{i,t}$.

IV. Result

The samples in this study are listed manufacturing companies in Indonesia from period 2010-2014. It should fulfill three criteria mentioned in previous chapter, 1) listed manufacturing company that publish financial statements persistently from year 2010-2014, 2) company use Rupiah as their functional currency 3) company has positive equity number. Based on these criteria, there are 86 companies that can be used as samples from period 2010-2014. Hence, the total final sample for this study is 430. The samples have been check thoroughly and all variable required can be obtained.

1. Normality Test, Multicollinearity Test, Heteroscedasticity Test, Autocorrelation Test

Tabel 3

Normality Test, Multicollinearity Test, Heteroscedasticity Test, Autocorrelation Test

No	Test	Result	Explanation
1	Normality Test	Probability Value > 0.05 , specifically 0.051	The data are normally distributed
2	Multicollinearity Test	All variable have VIF(Variance Inflation Factors) value < 10 and Tolerance value > 0.1	No Multicollinearity problem
3	Heteroscedasticity Test	All variable have Probability value > 0.05	No Heteroscedasticity problem
4	Autocorrelation Test	Durbin-Watson Value (DW) 1.89 is between dU 1.88 and 4-dU 2.12	No Autocorrelation Problem

2. Hypothesis Testing Analysis

Regression coefficients from the regression model can be seen in Table 4.8 below:

Table 4

Regression Result

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig [*]
	β	Std. Error			
1 (Constant)	-.704	.166		-4.239	.000
CONACC	-.007	.003	-.107	-1.985	.048
LEVERAGE	.103	.048	.119	2.152	.032
SIZE	.034	.006	.313	5.408	.000
AUDITOR	-.048	.022	-.132	-2.158	.032
Prob. F = 13.846					
Adjusted R-Squared = .133					

*Significant for $\alpha = 5\%$

Testing of this hypothesis is done by multiple linear regression model of the following:

$$DA = -0.704 - 0.007CONACC + 0.103LEVERAGE + 0.034SIZE - 0.048AUDITOR + \varepsilon$$

Where,

DA = Discretionary Accruals

CONACC = the level of conservatism

LEVERAGE = the level of company leverage

SIZE = the firm size represent by natural logarithm of total assets of the company

AUDITOR = the dummy variable that identify audit firm which perform audit process for the company

ε = error

The Conservatism variable as the independent variable in this study have significance value of 0.048 which is smaller than 0.05. The value of its β is -0.007. From this value, it can be seen that there is a negative relationship between Discretionary Accruals variable and Conservatism variable. The higher the level of conservatism will result in lower discretionary accruals. The lower the discretionary accruals mean the higher the earnings quality. Hence, the hypothesis of this study (H1) is accepted.

From the table above, it can be seen the coefficient of determination (Adjusted R-Squared) regression model used in this study. The value of Adjusted R-Squared is 0.133. This value show that independent variable, CONACC, and control variables, LEVERAGE, SIZE and AUDITOR can explain 13.3% variation of dependent variable, DA. The remaining value 86.7% is explained by other variables or factors beyond the regression model used in this study.

3. Discussion

Earnings quality represents the quality of information reported by manager to the users of financial statements. Good earnings quality will assist the users to make good economic decision. One of determinants of earnings quality is management decision, as mention in Francis et al. (2006). Management decision can either result in good earnings quality or bad earnings quality. The one that lead to personal gain and result in bias information, widely known as earnings management, will decrease earnings quality.

The discretionary accruals used as proxy for earnings management capture management decision in choosing accrual policy. This type of accrual is called abnormal accrual. The amount of discretionary accrual component that changes in financial statements is entirely due to management decision. While non-discretionary accrual component changes is due to company condition that require certain adjustment. The lower the discretionary accruals number means the lower the manipulation level of earnings number.

The statistic test show negative relationship between discretionary accruals and conservatism. It means the level of conservatism have opposite direction to the level of earnings management. If the level of conservatism increase then the level of earnings management decrease. If the level of conservatism decrease then the level of earnings management increase. Hence, it can be said that conservatism implementation within the company is decreased the level of earnings management practices.

From the result of statistical test, it can be seen that the hypothesis is accepted. Conservatism decrease earnings management practice, shown by negative relationship between discretionary accruals and conservatism. This finding supports previous studies, such as Watts (2003), Lafond and Watts (2008), Lara et al. (2012), and Haniati and Fitriany (2010) that found conservatism decrease earnings management. The decrease of earnings management practice means higher earnings quality. Hence, it is proved that conservatism principle increase earnings quality.

V. Conclusion and Suggestion

1. Conclusion

Based on the analysis and discussion in the previous chapter, this study has the objective to test the impact of conservatism principle to earnings quality. The earnings quality in this study is measured by accounting-based measurement for earnings quality, namely abnormal accruals or discretionary accruals. This study uses financials statements of 86 listed manufacturing companies in Indonesia from period 2010-2014 (5 years) as data. The total sample for this study is 430 samples.

The regression model used in this study is called multiple linear regression model. In order to meet the criteria of good regression model for parametric statistical hypothesis testing, the model should pass four classical assumption tests, which consist of normality, autocorrelation, multicollinearity, and heteroscedasticity. Based on the result of four classical assumption tests, the regression model used in this study meet the criteria of good regression model for parametric statistical hypothesis testing.

The result of the analysis shows that the hypothesis of this study is accepted. It means conservatism increase earnings quality of listed companies in Indonesia. In the context of earnings management as measurement for earnings quality, conservatism implementation will increase earnings quality by decreasing earnings management practice. From this result, the users of financial statement can see that conservatism gives positive impact to the quality of information reported in financial statements, especially earnings information.

2. Limitations and Suggestions

The main objective of this study is to find answer along with empirical evidence whether conservatism gives impact to earnings quality of listed companies in Indonesia. Based on the result, it is proved that conservatism gives positive impact to earnings quality. However, this result is limited to one context of earnings quality, which is based on abnormal accruals. This measurement of earnings quality is one of accounting-based measurements of earnings quality. There are several other accounting-based measurements, such as accruals quality, persistence, predictability and smoothness. In addition, there are market-based measurements of earnings quality.

Some suggestion and idea that can be used by future researchers;

1. Subsequent studies may use other accounting-based measurement of earnings quality, such as accruals quality, persistence, predictability and smoothness. For more perspective, future researcher can combine two or more measurement to find the average result of accounting-based measurement.
2. For Conservatism variable, future research may use other measurement, such as Basu Asymmetric Timeliness and negative non-operating accruals.

The period of the research can be extended up to more than five years in order to achieve better result. The samples can be expanded to other type of company beyond manufacturing.

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