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The Effect of IFRS Convergence on Earnings Quality: Empirical Evidence from Indonesia

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ABSTRACT

Objective –The purpose of this research is to examine the impact of the International Financial Reporting Standard (IFRS) convergence in Indonesia on earnings quality.
Methodology/Technique – Earnings quality is measured on both accrual earnings management and real earnings management. Indonesia began convergence IFRS in 2012. IFRS is considered capable of improving comparability, transparency, and earnings information, which is expected to ultimately improve earnings quality. The sample in this research uses manufacturing firms listed on the Indonesian Stock Exchange that were suspected to avoid loss during the observation period. The data consist of 45 companies examined between 2008 and 2015.
Results –This study uses statistical methods and multiple regression linear to analyse the data. The research results show that IFRS convergence in Indonesia has had a negative impact on accrual earnings management and no impact on real earnings management.
Novelty –The evidence shows that IFRS convergence in Indonesia has the ability to improve earnings quality related to a decrease in accrual earnings management but not real earnings management.
Type of Paper: Empirical

Keywords: IFRS; Discretionary Accrual; Abnormal Cash Flow Operation; Abnormal Production; Abnormal Discretionary Expenditure.

JEL Classification: M40, M41, M49

1. Introduction

The development of the global world, particularly in relation to accounting, is the result of agreements between several countries around the world which has lead to the development of an accounting standard aimed at minimizing the differences between accounting standards applicable around the world. This has lead

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to the implementation of the International Financial Reporting Standards (IFRS) in a number of countries (Daske et al., 2008). Most countries implement the IFRS, including Indonesia, which is expected to increase comparability, transparency, and improve the quality of accounting information. The IFRS also has economic consequences, such as an increases in liquidity, and a decline in the cost of capital (Daske et al., 2008; DeFond et al., 2011; Daske et al., 2013). Several studies have shown the ability of IFRS to improve earnings quality but in a less predictable and more volatile way (Gassen and Sellhorn, 2006; Morais and Curto, 2008; Rudra and Bhattacharjee, 2012), to decrease the cost of capital (Daske et al., 2008) and to increase the value relevance of accounting information (Kargin, 2013; Mousa and Desoky, 2014; Kousenidis et al., 2010). Indonesia began convergence with the IFRS on 1 January 2012.

On the one hand, the application of IFRS is deemed to be able to improve the relevance of principle- based accounting information to decrease the options available when deciding which accounting policies to adopt. A reduction in the flexibility when selecting policies or accounting methods, reduces the availability of residual values and estimates that can be used by managers to manipulate financial statements (Capkun et al., 2016).

The implementation of IFRS convergence is expected to improve corporate earnings quality. Earnings quality is measured by determining the amount of earnings management performed by the company (Schipper and Vincent, 2003; Lo, 2008; Dichev et al., 2013; Nelson and Skinner, 2013). The existence of earnings management, both accrual and real, in general does not violate the accounting principles or standards. The existence of earnings management however, does raise some ethical issue and this debate is ripe amongst academics and practitioners. The use of earnings management may mislead users of financial statements because they do not reflect the accurate condition of the company (Jooste, 2011).

Accrual earnings management practices typically receive the most attention. Accrual earnings management is a manipulation performed by management by manipilating the accrual concept, such as the selection of accounting methods, judgment estimation and residual value, allowance of receivables, and others (Scott, 2015). In contrast, real earnings management receives less attention, because it is more difficult to detect, however its impact on long-term performance is more significant (Roychowdury, 2006; Gunny, 2010; Kim and Sohn, 2008; Tabassum et al., 2015).

IFRS implementation is expected to have a positive impact on users of financial statements by improving the quality of information contained within them (Hung and Subramayam, 2007). A study by Krismiaji et al. (2016) indicates that in the period after the convergence of IFRS in Indonesia, there was an increase in the relevance and faithful representation of the quality of accounting information. Ismail et al. (2013) also indicates that the adoption of the IFRS in Malaysia also improved the quality of earnings. Similar research conducted by Ebaid (2016) suggests that the adoption of the IFRS improves the quality of accounting by decreasing the instance of earnings management in sample firms in Egypt. The results of these studies conclude that the adoption of the IFRS may improve the quality of earnings, by decreasing the discretionary accrual rate compared to the period prior to the adoption of earnings.

In contrast, the results of research conducted by Jeanjean and Stolowy (2008) examine the impact of IFRS in Australia, France and the United Kingdom on accrual earnings management; the results show no decrease in accrual earnings management in the period following IFRS implementation. Even accrual earnings management tends to increase after the adoption of IFRS in France. Xu (2014) also demonstrates that the IFRS do not reduce earnings management in private companies in the United Kingdom. In contrast to this, research conducted by Hastuti et al. (2016) with a sample of manufacturing companies listed on the Indonesian Stock Exchange between 2010 and 2014 indicates that the implementation of IFRS improves real earnings management.

The inconsistency between the results in previous studies provides motivation for the current study to reexamine the impact of IFRS convergence on manufacturing companies listed on the Indonesian stock exchange within different time periods. This study adds a test to real earnings management that has not been highlighted by prior studies, but has a negative impact in the future (Gunny, 2010; Kim and Sohn, 2008). The period in this study used the mandatory cut-off for implementation of the IFRS in Indonesia in 2012. The period between 2008 and 2011 is the period used as the period prior to the application of IFRS convergence, and the period between 2012 and 2015 is the period used as the period after the implementation of IFRS convergence.

2. Literature Review

2.1 Agency Theory

Jensen and Meckling (1976) define the agency relationships as a relationship arising from the existence of contracts between one or more principals, who use an agent to do act in the owner's interest. The owner or shareholder relies professional parties (management) to achieve their goal. This often creates a conflict of interest, due to the differences between each parties’ interests. The principal and agent both strive to maximize their welfare; the existence of such differences in interests is supported by the asymmetric conditions of information sharing between owners and management. Management has access to more information than the owners of the company and this encourages management to manipulate financial statements or engage in earnings management to maximize their own interests.

2.1.1 Accrual Earnings Management

Scott (2015) states that earnings management is the choice of a particular accounting policy based on management's decision to achieve specific goals that further their own personal interests. Sutrisno (2012) reveals that earnings management is a process of management using their own discretion to mislead shareholders, but are still within the limits of accounting principles or standards. Shareholders will receive a benefit if earnings management is used to increase corporate value and will be harmed if earnings management is used to generate a personal benefit for a manager or managers, such as increasing bonuses or adding personal wealth to managers.

Nini and Trisnawati (2009) states that the accrual basis principle in accounting gives a manager flexibility to determine the amount of accrual transactions, such as determination of uncollectable accounts receivable, warranty costs, inventory value and timing and extraordinary items. The selection of accounting methods and policies, such as the selection of depreciation methods, the determination of the residual value estimation and the estimated useful life can also provide management the opportunity to conduct accrual earnings management without violating the accounting rules or principles.

2.1.2 Real Earnings Management

Real earnings management refers to the manipulation of corporate earnings by cutting discretionary budget, sales manipulation by giving large discounts, and increasing overproduction (Roychowdhury, 2006; Cohen et al., 2008). The three manipulation methods used are:

(1) manipulation of sales to manipulate the time of revenue recognition, increasing sales discounts and providing leniency in the provision of credit sales to increase earnings or cash flow of the company instantaneously;

(2) overproduction: increasing production on a large scale to reduce Cost of Goods Sold (COGS). The high level of production will cause a spread of fixed overhead costs to a large number of products; and

(3) eliminating discretionary expenditure such as research and development, employee training, advertising, general and administration expenses.

Mizik and Jacobson (2007) state that the manipulation of accounting numbers with R&D expenditure (real earnings management) has a higher negative impact on the performance of a company than accrual earnings management. More specifically, this occurs when management focuses on short-term goals in excess to achieve certain earnings targets. Research conducted by Gunny (2010) and Tabassum et al. (2015) shows that real earnings management has a negative impact on the company's performance, declining the return on assets and cash flow in the future period, decreasing the return on equity, earnings per share and price earnings ratio. A survey conducted by Graham et al. (2005) states that companies that conduct real earnings management tend to have lower performance. On the other hand, real earnings management gives a positive signal in the short term by directly increasing the company's earnings, however this will become a negative signal in the long term.

2.2 IFRS Convergence and Earnings Management

Barth et al. (2008) shows that countries that have voluntarily adopted IFRS between 1994 and 2003 have lower levels of income smoothing than firms that have not implemented the IAS (International Accounting Standards).This shows that eliminating some of the alternative choices in determining accounting policies in fact reduces management discretion, thereby reducing management opportunities for opportunistic earnings management behavior, and improving earnings quality (Pascan, 2015). Similar results are demonstrated by Rohaeni and Aryati (2012) who examined the situation in Indonesia, Singapore and China between 2006 and 2010. This study demonstrates that IFRS convergence has a negative effect on income smoothing. Lopes at al. (2010) produced similar results when examining European companies, finding that the IFRS have a positive effect on earnings quality (measured using absolute abnormal accruals).

However, several studies have produced significantly different results. For example, Christensen et al. (2015) and Wang and Campbell (2012) show that there is no evidence showing an improvement in earnings quality following IFRS adoption. Handoyo and Budiharta (2014) also indicate that the application of IAS 32 and 39 does not affect the quality of earnings in the banking industry in Indonesia. Further, Tendeloo and Vanstraelen (2005) suggest that the voluntary adoption of IFRS amongst firms in Germany does not indicate a decline in earnings management; there is no difference in earnings management between companies that adopt IFRS and German GAAP. This is due to differences in the characteristics of the environmental, economic, and cultural conditions that result in IFRS adoption among certain countries not performing as expected (Daske at al., 2008). Research conducted by Procházka and Pelák (2015) also shows that earnings quality is determined not only on standard quality, but is also influenced by other factors such as quality of enforcement and adequacy of incentives for companies to report transparently. In addition, earnings management is based on the opportunistic behavior of management itself, aimed at maximising its welfare. Hence, the adoption or non-adoption of IFRS does not affect the choice of management to engage in earnings management (Ahmed et al. (2013). However, IFRS convergence does not guarantee the occurrence of earnings management (Kaaya, 2015). Based on this information, the hypotheses proposed in this research are as follows:

H1: There is an increase in the earnings quality as measured by the accrual earnings management in the period following implementation of the IFRS convergence.

H2: There is an improvement in the earnings quality as measured by real earnings management in the period following implementation of the IFRS convergence.

3. Research Methodology

The sample used in this study are all manufacturing companies listed on the Indonesian Stock Exchange between 2008 and 2015. The sample selection method used in this research is companies reporting earnings in financial statements (to avoid loss).

3.1 Research variable

3.1.1 Accrual Earnings Management

This research uses (Dechow et al., 1995) to show that profit management calculations consist of Total Accruals (TACC), Non-Discretionary Accruals (NDA) and Discretionary Accruals (DA). Discretionary accruals are components of abnormal accruals, derived from the results of manipulation performed by the management company. The formula for calculating discretionary accruals is as follows:

$$DAit = TACCit - NDAit \qquad (1)$$

Total Accruals are derived from the net income before extraordinary items, less current operating cash flows. The formula for calculating total accruals is as follows:

$$TACCit = (NIit - OCFit) \qquad (2)$$

Information: Nit: net profit period t; OCFt: the cash flows from the company's operating activities in period t.

Non-discretionary accruals are part of the total accruals earned from the normal operation of the company calculated as follows:

$$TACCit/TAit\text{-}1=\alpha 1(1/TAit\text{-}1)+\alpha 2(\Delta REVit\text{-}\Delta RECit/TAit\text{-}1)+\alpha 3(PPEit/TAit\text{-}1)+\square it \qquad (3)$$

Information: ΔREVit: changes in company earnings i from year t-1 to year t; ΔRECit: changes of receivables i from year t-1 to year t; PPEit: gross plant, property, equipment company i in period t; □it: residual company i in period t.

3.1.2 Real Earnings Management

Real profit management, which is proxied with abnormal cash flow, (AbnCFO), abnormal production cost (AbnPROD), and abnormal discretionary load (AbnDISEXP) is calculated using the following formula:

CFOt / At-1 = α1 (1 / At-1) + □1 (St / At-1) + □2 (□St / At-1) + □t (4)

CFOt is the operating cash flow period t, divided by total assets of period t-1, St is sales in period t, and □St is sales difference in period t and t-1.

Abnormal production cost (AbnPROD) is obtained by first estimating the model as follows:

PRODt / At-1 = □1 (1 / At-1) + □1 (St / At-1) + □2 (□St / At-1) + □3 (□St-1 / At-1) + □t (5)

PRODt is the production cost in period t, divided by total asset in period t-1, PRODt = COGSt + □□□Vt, St is sales in period t, □St is sales difference in period t and t-1, and □St- 1 is the sales difference in period t-1 and t-2.

The abnormal discretionary expenditure (AbnDISEXP) is obtained by first estimating the model as follows:

$$DIEXPt / At\text{-}1 = \alpha 1\ (1 / At\text{-}1) + \square 1\ (St\text{-}1 / At\text{-}1) + \square t \qquad (6)$$

DIEXPt is discretionary expense in period t, divided by total asset in period t-1, St is sales in period t-1.

3.2 Research Model

This study tests two conditions at different points in time; before and after IFRS convergence. Model 1 of this research is as follows:

$$DA = \square 0 + \square 1AIFRS + SIZE + \square$$

Information: DA: discretionary accrual; AIFRS: period before and after IFRS convergence (dummy variable; 1 = Period after IFRS convergence (2012-2015); 0 = Period before IFRS convergence (2008-2011); SIZE: company size (Ln total assets)

Model 2 of this research is as follows:

$$AbnCFO + AbnProd + AbnDISEXP = \square 0 + \square 1AIFRS + SIZE + \square$$

The calculation of real earnings management refers to Cohen et al. (2008) that is the sum of standardized residual of AbnCFO, AbnProd and AbnDISEXP values.

4. Results

Table 1 shows the descriptive statistics. The sample data consists of all manufacturing companies listed on the Indonesian Stock Exchange between 2008 and 2015, that avoided reporting losses. This resulted in 45 companies being studied, with a total of 360 data surveys being obtained. The descriptive statistics show the absolute mean value of accrual earnings management is 0.06218, with a standard deviation value of 0.07001, minimum value of 0.00013 and maximum value of 0.70854. The study uses absolute value, because it does not examine whether companies do earnings management by increasing or decreasing income, but rather measures the amount of earnings management conducted by the company.

The mean value of real earnings management is -0.00000056. This figure is very small because real earnings management figures are a combination of the three real profit management proxies. The standard deviation value is 1.16281, with a minimum value of -5.74573 and a maximum value of 11.27. IFRS is the period of application before IFRS convergence with value 0, while the period after IFRS convergence is given value 1. Company size is the controlled variable added to model, with an average value equal to Rp9,909,223,688, a standard deviation equal to Rp27,652,744,903, a maximum value of Rp242,392,000,000 and a minimum value of Rp68,325,233.

Table 1. Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
ABSDA	360	0.00013	0.70854	0.06218	0.07001
REM	360	-5.74573	11.27	-0.00000056	1.16281
IFRS	360	0	1	0.5000	0.50070
LNTA	360	18.03979	26.21	21.4509	1.66968
TA	360	68325233	242392000000	9909223687.7806	27652744903.4345

The regression analysis shows that in model 1, the F value of the statistics show the significance level is smaller than 0.05, so that model 1 is fit to use, whereas in model 2, the F statistic shows a significance value greater than 0.05, so model 2 is not feasible. The result of the test of model 1 concludes that in the period after the convergence of IFRS, there is a tendency to decrease the value of earning management accrual compared to the period before IFRS convergence. This is shown through the significance value of less than 10%, with a coefficient of -0.013. The results of the research for model 1 concludes that IFRS convergence improves the quality of earnings, whereas in model 2, it can not be concluded whether in the period after IFRS convergence the quality of earnings increases because F is statistically insignificant. The result of the F statistic is not significant in model 2 because of the insufficient sample used, and the inability to measure real earnings management.

Table 2. Hypothesis Testing

Variable	Model 1 ABSACC	Model 2 REM
Intercept	0.0164	0.468
	0.001	0.556
IFRS	-0.013	0.167
	0.077*	0.18
SIZE	-0.004	-0.026
	0.046**	0.49
R2	0.023	0.006
Adj R2	0.018	0.000089
F	4.273	1.016
Sig F	0.015**	0.363

*) sig 10% **) sig 5%

5. Discussion

This study aims to contribute to the impact of IFRS convergence on earnings quality. The results of this study indicate that IFRS convergence in Indonesia improves the quality of earnings by decreasing the level of earnings management as measured by discretionary accrual. This is because IFRS improves the transparency of financial reporting, thus limiting the ability of management to conduct accrual earnings management, to improve the quality of earnings. However, the results of the study are not able to demonstrate whether, in the period after the convergence IFRS, there is a decline of real earnings management. This is most likely because the measurements used to calculate real earnings management in this study are not yet appropriate and the number of samples used is limited.

6. Conclusion

This study shows that IFRS convergence improves the quality of earnings by reducing accrual earnings management but has no effect on declining real earnings management. Future research in this area may use a larger test sample by using a period of observation between 2003 and 2007 as the period before IFRS convergence and between 2012 and 2016 as the period after IFRS convergence. The 2008 to 2011 period should be removed from the test because this was a period of transition for IFRS convergence, which may influence the research results. With respect to the measurement of real earnings management, future research may use time series calculations of each real earnings management proxy, to find an appropriate measurement of the data from manufacturing companies in Indonesia.

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