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Affiliation: Petra Christian University, Jl. Siwalankerto 121-131, 60236, Surabaya, Indonesia

Keywords: Conservatism; Earning Quality; IFRS Adoption; Indonesia; Pre and Post-adoption.

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Keywords: Bid-ask Spread; Cost of Capital; Information Asymmetry; IFRS Adoption.

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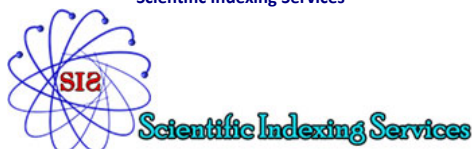
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The Accounting Conservatism of the Adoption of IFRS in Indonesia

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ABSTRACT

Objective – The Indonesian Accounting Standard Authority has required companies to adopt the International Financial Reporting Standard (IFRS) since its adoption in 2012. The new standard emphasizes relevance, while the previous standard focused on conservative issues. While the IFRS does not specifically aim to reduce conservatism, this aspect is no longer the emphasis of the new standard. There are concerns about whether the IFRS reduces conservatism and the research on this issue are still uncertain. Hence, this study aims to determine the level of conservatism in the period following the adoption of the IFRS. The study also aims to examine the outcome of the adoption of the IFRS since its adoption in Indonesia in 2012.

Methodology/Technique – Using the accounting conservatism model developed by Basu (1997), the authors compare firm conservatism before and after the adoption of the IFRS. The sample includes companies listed on the Indonesian Stock Exchange between 2006 and 2016. There are 3,742 firm-years that consist of 394 companies from various industrial sectors. The data is analyzed using a Pooled Least Square method.

Findings – The results show that conservatism was high prior to the adoption of the IFRS. Further, accounting earnings are more sensitive to the negative return than to the positive return before the adoption of the IFRS. However, in the post-adoption period, sensitivity to negative return has decreased. This means that the adoption of the IFRS has reduced levels of conservatism. The Indonesian Accounting Standard Authority may rely on these results to evaluate the mandatory policy of IFRS.

Novelty – This study explores the prevalence of conservatism within firms prior to, and following, the adoption of the IFRS using longitudinal data.

Type of Paper: Empirical.

Keywords: Conservatism; Earning Quality; IFRS Adoption; Indonesia; Pre and Post-adoption.

JEL Classification: M41, M48.

1. Introduction

In the global era, international financial standards must synchronize information contained in financial reports of various countries to enable it to be used by those who need it. Indonesia, as a member of the G20, has fully adopted the International Financial Reporting Standard (IFRS) into its local standard, i.e. the Statement of Financial Accounting Standard (Ikatan Akuntan Indonesia, 2017).

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The adoption of the IFRS affects earnings quality through reliable accounting information (Yurt & Ergun, 2015; Krismiaji et al., 2016).

IFRS places increased emphasis on relevance; the standard offers an option to choose a fair value in presenting assets or liabilities in financial statements. The principle of fair value enables companies to present their financial information appropriately to investors (Barth et al., 2008; Yen et al., 2016). There is a large body of evidence from prior studies that the adoption of the IFRS in developed countries increases earnings quality (Chen et al., 2010; Houque et al., 2015; Manganaris et al., 2016; Okafor et al., 2016). This result seems consistent with many of the studies conducted in developing countries (Ismail et al., 2013; Chebaane & Othman, 2014; Krismiaji et al., 2016; Outa et al., 2017).

The IFRS is therefore a useful tool for financial accounting, however, some opponents of the IFRS highlight the conservatism problem inherent in the new standard. Some are concerned that the increased focus on the issue of relevance will necessitate an ignorance of other essential principles of financial reporting, namely, conservatism (Watts, 2003; Hellman, 2008; Rebecca et al., 2015). The relevance principle in the IFRS requires firms to present their assets and liabilities at a fair value. This means that under the IFRS, companies will immediately recognize unrealized gain or unrealized loss when it occurs. The IFRS does not deny loss whenever the cost is below market value; it aligns with the conservative principle that requires companies to recognize loss immediately (Basu, 1997). With respect to relevance, the adoption of the IFRS should not reduce the level of conservatism.

However, there are currently no concrete results concerning whether the adoption of the IFRS has reduced levels of conservatism in financial reporting. Some prior studies have found that the adoption of the IFRS decreases the level of conservatism (Hellman, 2008; Andre & Filip, 2012; Andre et al., 2013; Lu & Trabelsi, 2013; Januarsi et al., 2014; Zeghal & Lahmar, 2016). Other studies have shown that the IFRS increases conservatism (Gassen et al., 2006; Barth et al., 2008; Lin et al., 2012; Bertin & Moya, 2013; Pulungan, 2014; Dobre et al., 2015). Other studies have even failed to adequately measure and quantify conservatism levels following the adoption of the IFRS (Juanda, 2012; Hikmah, 2013; Sousa et al., 2016; Ghani et al., 2017; Prayanthi & Pantow, 2018).

These studies have been carried out in many different countries, with the unique institutional environments of common law and code law, which may possibly be the cause of diversification in the results (Barth et al., 2008; Karampinis & Hevas, 2011; Andre & Filip, 2012). In code-law countries such as Indonesia, accounting standards are compiled by standard authorities under state control and weak investor protection that does not prioritize public disclosure (Karampinis & Hevas, 2011). The adoption of the IFRS encourages code-law countries to consider public disclosure. Therefore, this study aims to contribute to the literature by uncovering empirical evidence to demonstrate that the adoption of the IFRS in code-law countries, specifically in Indonesia, does not reduce conservatism.

In Indonesia, the IFRS was adopted in 2012. In contrast to previous research, which has been carried out in specific sectors only and hence does not produce sufficiently representative results, (Prayanthi & Pantow, 2018; Ghani et al., 2017; Januarsi et al., 2014; Pulungan, 2014; Hikmah, 2013), this research examines all industrial sectors. To obtain more accurate results, longitudinal data is used. There are 3,742 observations consisting of 394 firms for the period between 2006 and 2016.

The results show that, prior to the adoption of the IFRS in Indonesia, accounting conservatism was ripe. However, following the adoption of the IFRS, the sensitivity to recognize negative returns in a timely way has declined. It can be concluded that the adoption of the IFRS in Indonesia therefore reduces conservatism. Robustness testing has been conducted to verify the results.

The study is organized as follows. Section 2 discusses the theoretical basis and the development of the hypotheses. Section 3 presents the research methods. Sections 4 and 5 describe the analysis and discussion, respectively, including the empirical findings. The last section discusses the conclusions and limitations of this study.

2. Theoretical Background and Hypotheses Development

2.1 Adoption of IFRS in Indonesia

The development of accounting standards in Indonesia occurred between 1973 and 1984. During that time, the Indonesian Accounting Association (IAI) formed the Indonesian Accounting Principle Committee which established Indonesian Accounting Principles (PAI). In 1984, the PAI revised PAI of 1973, which gave rise to the new standard: PAI of 1984. At the end of 1994, the Indonesian accounting standard was revised once again, and 35 coherent accounting standard statements were issued with the International Accounting Standard. From 1994 to 2004, several orientation shifts occurred in the Indonesian accounting standard from the US GAAP to the International Accounting Standards (Saputra & Hermawan, 2012).

IAI states that the Indonesian accounting standard would fully converge with the IFRS in 2008. Thus, the first stage of convergence with the IFRS occurred between 2006-2008. However, as at the end of 2008, the Indonesian accounting standard had only adopted 10 of the IFRS standards (out of 30). Therefore, the adoption of the IFRS continued between 2008-2010. Furthermore, the stage continued with the end-of-the-year preparation stage in 2011 and the implementation of the IFRS in Indonesia in 2012.

The fundamental difference between the US GAAP and the IFRS is that the US GAAP is rule-based, while the International Accounting Standards is principle-based (Schroeder et al., 2013). A rule-based standard is a detailed principle in the standard implementation that reduces uncertainty. A principle-based standard utilizes estimations that the accountants must be held responsible for, and requires a considerable amount of professional judgment. Furthermore, the US GAAP emphasizes historical costs, while the IFRS uses the fair-value approach. Fair value is the price that will be received on asset sales or obligation returns in a transaction as at the measurement date.

The benefits of the IFRS are relevant to business because it increases transparency, accountability and the comparability of financial statements (IFRS, 2018). IFRS brings about transparency by increasing the quality of financial information so that financial statement users will be able to make correct financial decisions. The IFRS also reduces the information gap between the capital holder and management, to increase accountability. With the IFRS, financial statements around the world can be compared to one another, and investors can identify opportunities and risks more easily. Thus, economic efficiency can be increased. Moreover, the IFRS can reduce the cost of capital and other international reporting fees.

2.2 Conservatism

Conservatism is the principle of prudence in financial reporting and diversities in the verifiability of profit and loss (Watts, 2003). The application of conservatism may encourage a company to admit negative financial reports faster than positive ones (Basu, 1997). Hence, conservatism requires greater verification of good news than bad news in financial reports. The higher the difference in verification between bad news and good news, the higher the conservatism level. Thus, conservatism may lead to earnings being understated in financial statements (Watts, 2002).

There are two types of conservatism: conditional conservatism and non-conditional conservatism (Chan, 2009). Non-conditional conservatism, or ex-ante, is related to the balance sheet. In the business environment, non-conditional conservatism is independent of good news and bad news. One example of non-conditional conservatism is the use of depreciation allocation methods with multiple declining balances, so that the book value of an asset is understated. Earnings that are generated by non-conditional conservatism are more consistent in the long-term.

Conditional, or ex-post conservatism, was established by Basu (1997). This type of conservatism relies on the news. Conditional conservatism is the difference in information verification that affects gains and losses in the business environment, which may eventually affect earnings. Accounting is considered to be

conservative if loss recognition is more on time than profit recognition. Conditional conservatism produces an earnings flow that is less consistent in length and more difficult for investors to detect.

The benefits of conservatism remains controversial (Savitri, 2016). Conservatism may limit managers' actions to exaggerate profits or assets and reduce conflicts between management and shareholders (Ahmed et al., 2002). However, Basu (1997) states that conservatism is a biased accounting system as it recognizes losses faster and profits slower, and assesses assets with the lowest values and liabilities with the highest value. Therefore, it results in low-quality earnings and less relevant reporting.

2.3 Hypotheses Development

The requirement to adopt the IFRS in Indonesia by 2012 has caused an alteration in financial reporting principles within that region. The purpose of adopting the IFRS is to improve earnings quality. One measurement of earnings quality uses conservatism (Dechow & Schrand, 2004). The conservatism level of financial reporting immediately recognizes the possibility of loss, so that the loss is recognized following the fair value. The IFRS does not disregard conservatism as it follows the guideline of value relevance (Chen et al., 2010; Ismail et al., 2013; Chebaane & Othman, 2014; Houqe et al., 2015; Krismiaji et al., 2016; Manganaris et al., 2016; Okafor et al., 2016; Outa et al., 2017). In the IFRS, the possibility of loss is recognized on time, similar to the conservatism principle. The IFRS will protect all stakeholders of the company through transparent and reliable financial reports. The adoption of the IFRS in emerging countries, particularly Indonesia, is the first step to improving the transparency of financial reports through the disclosure of favorable conditions to avoid unexpected company failures.

The IFRS adopts a fair-value measurement principle, which enables a company to recognize financial statement instruments based on fair value. If the fair value is lower, then the company will immediately recognize losses based on market value, and vice versa (Marzuki & Wahab 2016). The fair-value method gives rise to the possibility to book an increase or decrease in the value of assets that will affect company profit (Deloitte, 2017). When the asset value decreases, the company will immediately recognize the loss. In this way, the IFRS provides benefits by increasing the timeliness of recognition of bad news (losses) and good news (profits) at once, without causing differences in the accuracy of time recognition between the two. Therefore, the IFRS maintains conservatism.

This aspect of analysis is supported by previous studies which state that there are no significant changes in conservatism following the adoption of the IFRS (Juanda, 2012; Hikmah, 2013; Sousa et al., 2016; Ghani et al., 2017; Prayanthi & Pantow, 2018). Based on this, the following hypothesis is proposed:

H1. The level of conservatism does not change following the adoption of the IFRS.

3. Research Methodology

3.1 Analysis Model

The model put forward to test the hypothesis is formulated as follows:

$$AC_{it} = \alpha + \beta_j IA_{jit} + \varepsilon_{it} \quad (1)$$

where:

AC = Accounting conservatism company i

IA = IFRS adoption company i

a = Constant

b = Regression coefficient

Ei = error terms

3.2 Operational Variable Definition

3.2.1 International Financial Reporting Standard (IFRS)

This variable is measured using dummy variables. The company is considered to have adopted the IFRS if the company uses IFRS-based PSAK in its financial reporting. Companies that have adopted the IFRS will be given code 1, and companies that have not adopted the IFRS will be given code 0.

3.2.2 Conditional Accounting Conservatism

This research applies asymmetric earnings timeliness measurements, following the Basu (1997) model. The Basu (1997) model uses the piecewise-linear regression model. The measurement of good and bad news is achieved using annual earnings. The stock price will be used as a measurement of the news collection during one period, as stock price is a proper description of all information on the stock market. Therefore, the model is:

$$\frac{X_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 * DRET_{it} + \beta_0 * SRET_{it} + \beta_1 * SRET_{it} * DRET_{it} + \varepsilon_{it} \quad (2)$$

To examine the effect of the adoption of the IFRS, the dummy variable of the IFRS is added to the Basu (1997) model in equation 1. Hence, the conservatism model is:

$$\frac{X_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 * DRET_{it} + \beta_0 * SRET_{it} + \beta_1 * SRET_{it} * DRET_{it} + \gamma_0 * PREPOST_{it} * SRET_{it} + \gamma_1 * PREPOST_{it} * DRET_{it} + \gamma_2 * PREPOST_{it} * SRET_{it} * DRET_{it} + \varepsilon_{it} \quad (3)$$

where:

X = company i's earning per share on year t

P = company i's price per share on year t

SRET = company i's stock return on year t

DRET = 1 if SRET < 0 and 0 if vice versa

PREPOST = 1 for the adoption of IFRS and 0 if vice versa

3.3 Research Sample

The sample companies were collected from all industries in Indonesia: the consumer goods industry, basic and chemicals industries, finance, mining, agriculture, property, real estate and construction, infrastructure, utilities, transportation and various other industries. The results of this research are expected to be able to be generalized to all public companies listed on the Indonesian Stock Exchange. The criteria for selecting the samples in this research are: (1) the company was listed on the Indonesian Stock Exchange by 2010, and (2) the company remains a public company as of 2018. Stock prices and accounting data are taken from Bloomberg and Yahoo Finance.

4. Results

Overall, 394 companies were chosen, with a total sample of 3.742 book-years. The data in this study represents all industrial sectors. Table 1 shows the results of the screening process using the stated criteria, while Table 2 shows the composition of samples grouped by each industrial sector.

Table 1. Selection of Samples

Criteria of Sample	Total Companies
Total companies listed on the Indonesia Stock Exchange	555
Total companies conducted IPOs after 2010	(156)
Total companies delisted in 2018	(5)
Total companies that fulfill the criteria	394
Total sample by firm-year (394 companies x 11 years)	4.334
Total missing data	(592)
Total sample used	3.742

Table 2. Samples per Industrial Sector

Industrial Sector	Total	%
1 Miscellaneous industry	34	9%
2 Consumer goods industries	31	8%
3 Chemical and basic industry	55	14%
4 Infrastructure, utilities and transportation	30	8%
5 Finance	67	17%
6 Trade, services and investment	91	23%
7 Mining	32	8%
8 Agriculture	13	3%
9 Property, real estate	41	10%
Total	394	100%

Table 3. Descriptive Statistics (All Samples) -

Variable	Mean	Median	S.D.	Min	Max
EPSPRICE	0.0954	0.0545	1.51	-18.0	59.1
SRET	0.139	0.0197	1.31	-2.19	51.9
SRETDRET	-0.140	0.000	0.265	-2.19	0.000
PREPOSTSRET	0.0962	0.000	1.23	-1.99	51.9
PREPOSTDRET	0.239	0.000	0.426	0.000	1.00
PREPOSTSRETDRET	-0.0797	0.000	0.201	-1.99	0.000

Table 4. Descriptive Statistics Before IFRS Adoption

Variable	Mean	Median	S.D.	Min	Max
EPSPRICE	0.199	0.0595	2.24	-18.0	59.1
SRET	0.118	0.000	0.749	-2.19	10.3
SRETDRET	-0.167	0.000	0.300	-2.19	0.000

Table 5. Descriptive Statistics in After IFRS Adoption

Variable	Mean	Median	S.D.	Min	Max
EPSPRICE	0.0258	0.0519	0.660	-14.3	9.53
SRET	0.151	0.0315	1.54	-1.99	51.9
SRETDRET	-0.125	0.000	0.241	-1.99	0.000

The mean from EPSPRICE before the adoption of the IFRS in Indonesian companies was 0.199, while after the adoption of the IFRS, it was 0.0258. The mean decrease of the IFRS demonstrates that shares before the adoption of the IFRS were more undervalued than after the adoption of the IFRS. The higher the EPSPRICE value, the more shares that are undervalued. Overall, the EPSPRICE mean is 0.0954. The standard deviation of the EPSPRICE is 1.51, which means that the data between individuals with the mean shows small deviation only. The minimum EPSPRICE value is -18, and the maximum EPSPRICE value is 59.1.

Before the adoption of the IFRS, SRET had a mean value of 0.118, whilst the mean value was 0.151 following the adoption of the IFRS. This shows an increase in stock returns following the adoption. The mean value of SRET before the adoption of the IFRS is 0.139 and 0.0962 after. In the pre-adoption period, SRET has a standard deviation of 1.31, a minimum value of -2.19, and a maximum value of 51.9. For the post-adoption period, IFRS has a standard deviation of 1.23, a minimum value of -1.99, and a maximum value of 51.9.

SRETDRET had a mean of -0.167 before the adoption of the IFRS and -0.125 after. From before the IFRS adoption period to after the IFRS adoption period, there was a consistent increase in SRETDRET mean value as a whole from -0.140 to -0.0797. In the IFRS pre-adoption period, the standard deviation of SRETDRET is 0.265 with a minimum value of -2.19 and a maximum value of 0. After the IFRS adoption, the standard deviation of SRETDRET is 0.201, with a minimum value of -1.99 and a maximum value of 0.

4.1 Hypothesis Testing

The hypothesis testing uses the IFRS independent variable as measured by the dummy variable on the dependent variable, which is measured by earnings per stock return. Table 6 shows the results of the regression equation.

Table 6. Hypothesis Testing

	Coefficient	Std. Error	t-ratio	p-value
Const	0.0353054	0.0304823	1.158	0.2468
SRET	-0.0822891	0.0559550	-1.471	0.1415
DRET	0.395812	0.0934499	4.236	<0.0001 ***

SRETDRET	0.306007	0.173503	1.764	0.0779	*
PREPOSTSRET	0.0730370	0.0575709	1.269	0.2046	
PREPOSTDRET	-0.344310	0.107938	-3.190	0.0014	***
PREPOSTSRETDRET	-0.289740	0.226149	-1.281	0.2002	

The test was conducted on 399 Indonesian companies in all industrial sectors. The results show that the adoption of the IFRS has a negative effect on conservatism. DRET has proven to be significantly positive, even though SRET, as an absolute number, is insignificant. Before the adoption of the IFRS, the significance of DRET showed that accounting earnings are more sensitive to negative returns than positive returns. However, as supported by SRETDRET, which is positive and quite significant, the result indicates that prior to the adoption of the IFRS, accounting profit included a higher number of negative returns than positive returns. This demonstrates that conservatism existed even before the adoption of the IFRS. When SRET is associated with PREPOST, it becomes PREPOSTSRET, and it is consistently insignificant because SRET itself is insignificant. PREPOSTDRET is significant, however, it has a negative sign. This means that the sensitivity of accounting earnings over negative returns rather than positive returns has decreased. This shows that there is a decrease in conservatism following the adoption of the IFRS. Furthermore, PREPOSTSRETDRET is not significant because SRET and PREPOSTSRET are not significant. However, from the F test results, the significance level is 0.000040, which is below 0.05. This indicates that SRET, DRET, SRETDRET, PREPOSTSRET, PREPOSTDRET and PREPOSTSRETDRET significantly affect EPSPRICE.

4.2 Robustness Testing

To verify the results of the hypothesis testing, additional testing was conducted by grouping the samples into two categories: before IFRS adoption and after IFRS adoption. Tables 7 and 8 present the test results.

Table 7. Hypothesis Testing for Pre-IFRS Adoption

	Coefficient	Std. Error	t-ratio	p-value
const	0.143886	0.0920040	1.564	0.1181
SRET	-0.150197	0.100077	-1.501	0.1336
DRET	0.287231	0.165438	1.736	0.0828 *
SRETDRET	0.373915	0.274513	1.362	0.1734

Table 8. Hypothesis Testing for Post-IFRS Adoption

	Coefficient	Std. Error	t-ratio	p-value
const	-0.00402836	0.0175093	-0.2301	0.8181
SRET	-0.00458224	0.00888831	-0.5155	0.6062
DRET	0.0908356	0.0351895	2.581	0.0099 ***
SRETDRET	0.0115973	0.0716279	0.1619	0.8714

The results indicate that following the adoption of the IFRS, there is a consistent decrease in conservatism compared to the results of previous hypothesis testing. Both of the DRET groups are significant and positive,

while the results for the IFRS pre-adoption period indicate that accounting profit is more sensitive to negative returns. However, the sensitivity decreases within the IFRS post-adoption period, as shown by the decrease in the DRET coefficient from 0.287231 to 0.0908356. The absolute numbers from DRET and SRET, both in the pre-adoption and post-adoption period, are consistently insignificant. When SRET is linked to DRET in both of the groups, SRETDRET was insignificant. From the F test results, with a significance below 0.05, SRET, DRET and SRETDRET all significantly affect EPSPRICE in both the pre and post-adoption period.

5. Discussion

The result of the research shows that the adoption of the IFRS has a significantly negative influence on conservatism. These results are consistent with IFRS adoption testing on conservatism, as it is split into the period before and after IFRS adoption. Therefore, IFRS does not maintain conservatism.

IFRS stresses the relevance of fair value, in which losses and gains are recognized under fair value. In contrast, under conservative principles, only loss is recognized at fair value. Therefore, following the adoption of the IFRS, earnings contain gains and losses, unlike conservatism, which contains only losses. This means that conservatism practice has decreased in the post-adoption period, which is indicated by the decrease in sensitivity of return to earnings. Investors must take this into account when making investment decisions as these results indicate that the IFRS cannot protect stakeholders. Thus, investors have to analyze the accounting information of the company with great detail.

The IFRS is predicted to improve earnings quality. However, the results indicate that the adoption of the IFRS decreases conservatism, which is one measurement of earnings quality (Dechow & Schrand, 2004). As a result, the goal of the IFRS cannot be achieved. Therefore, the Indonesian accounting standards authority must be aware of the obligations of the adoption of the IFRS in Indonesia that result in a decline in conservatism. Further, based on this research, management must realize that the adoption of the IFRS may reduce conservatism. When conservatism decreases, the quality of earnings decreases, which contradicts relevance. This phenomenon may reduce the quality of decisions of IFRS-based financial statement users.

6. Conclusion

This research aims to determine the level of conservatism following the adoption of the IFRS. The results show that, while the practice of conservatism did exist before the adoption of the IFRS, it does not appear that conservative practices have continued in the post-adoption period. This is indicated by the decrease of accounting earnings sensitivity toward the recognition of negative returns. The results are proven to be robust through additional testing whereby the samples were grouped into two periods: pre-adoption and post-adoption.

Due to the decrease in conservatism following the adoption of the IFRS, investors must analyze accounting information in greater detail, due to the decrease in the return sensitivity to accounting earnings. Further, the Indonesia accounting standard authority must be aware of the decline in conservatism, which implies a decrease in earnings quality. Furthermore, management must be aware that the adoption of the IFRS may reduce conservatism, which contradicts relevance.

This research has some limitations. First, only one type of conservatism is examined: earnings per stock return. Future research may wish to compare the two types of conservatism to draw a comprehensive conclusion about the status of conservatism following the adoption of the IFRS. Second, this study also opens the venue for future study to exercise conservatism issues by controlling the level of corporate governance either at firm level or country level.

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