The Effect of IFRS Adoption on Earnings Management in Indonesia: The Moderating Role of Investor Protection Empirical Study on Manufacturing Companies

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Abstract: This study aims to examine the effect of IFRS adoption on an earnings management level and considers the effect of investor protection as a moderating variable on the negative relationship between IFRS adoption and earnings management. The samples in this study were manufacturing companies on the Indonesian Stock Exchange in 2010–2015. Samples were selected using a purposive sampling method. The data used in this study was analyzed using Moderated Regression Analysis (MRA) with SPSS 20. The results demonstrate that there was a negative relationship between IFRS adoption and earnings management and, with the influence of investor protection as a moderating variable, the negative relationship between IFRS adoption and earnings management was strengthened.

1 INTRODUCTION

An increasingly integrated world market provides the firm with opportunities for developing its capital and conducting transactions between countries without being restricted by its own geographical position. Therefore, it is required that there is a single high-quality international accounting standard. The use of financial statements, which are one of the firm's main communication tools to investors, will be increased if there is a mutual language around the world: the global accounting standards. The International Accounting Standards Board (IASB) conceptual framework identifies relevance and presentation fairly as a basis for qualitative characteristics in financial statements, so that they provide beneficial accounting information for investors and other stakeholders regarding economic decision-making.

Driven by the above fact, the issue of accounting standards harmonization has begun to emerge. This harmony was finally realized with the publication of the International Financial Reporting Standards (IFRS) in June 2003. As explained by Ball (2006), the IFRS is an international accounting standard that aims to equalize accounting standards of financial reporting among public firms around the world. He states that the main benefit of the IFRS to investors is an improved accounting quality, and more accurate, comprehensive, and timely financial reporting information.

There are two types of strategies for the adoption of IFRS: the big bang strategy and the gradual strategy. The big bang strategy adopts IFRS immediately, without going through stages. Meanwhile, the gradual strategy is a more progressive IFRS adoption that has certain stages. The IFRS adoption in Indonesia has been gradual since 2008 and infrastructure preparation began in 2011 to support the implementation of PSAK, which has already adopted IFRS. Indonesia is facilitated by IFRS conduct so transactions can be shared with foreign firms and will gain access to international funding as financial statements will be more easily communicated to global investors.

The adoption of a set of accounting standards such as IFRS improves the quality of earnings because management is under pressure to provide fair statements and reduce involvement in earnings management practices (Houqe et al., 2012). This was also expressed by Ewert and Wagenhofer (2005), who observed that high-quality accounting standards would reduce earnings management practices and improve the quality of financial reporting. Consequently, FRS adoption in Indonesia

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in PSAK is also expected to reduce earnings management practices and produce high-quality accounting information.

Differing interests between owner and management may result in conflict because each party wants to maximize its own interests (Jensen & Meckling, 1976). The presence of information gaps and conflicting interests between the management and stakeholders will lead to problems of information asymmetry (Haely & Pahlepu, 2001). The condition of information asymmetry is actually the cause of earnings management. According to Scott (2012) earnings management is an act chosen by management within accounting policies to affect earnings but is still within the limits allowed to achieve a certain level. IFRS adoption limits management's flexibility in earnings management practice and improves the quality of accounting information (Dimitropoulos et al., 2013). However, principle-based space or flexibility in the IFRS, coupled with a lack of IFRS enforcement, will provide an opportunity to achieve earnings management (Barth et al., 2008).

Many empirical studies have proven the decreasing earnings management level after IFRS was adopted (Barth et al., 2008; Dimitropoulos et al., 2013; Ewert & Wagenhofer, 2005). Wardhani (2009), who examined the effect of the IFRS convergence rate in 10 countries in Asia, reported that IFRS has an effect on earnings quality, which means a decrease in the earnings management level. On the other hand, there are also studies that prove that the adoption of IFRS has no effect on the earnings management level. Janjean and Stolowy (2008), whose research examined the impact of the IFRSs mandatory adoption associated with earnings management, indicated that there was no decrease in earnings management as a result. Barth et al. (2008) explains the likelihood that such discrepancies are due to a gradual shift from local accounting standards to the IFRS that may affect the effects of its adoption, and the lack of infrastructure to enforce the use of it. Houqe et al. (2012) examined the effects of investor protection at country level regarding the IFRS adoption relationships with earnings management in 46 countries. The results of the study demonstrated that earnings management will decrease when IFRS adoption is accompanied by strong investor protection in the country.

Based on the facts in previous studies, this study aims to examine whether there is an impact of IFRS adoption on the earnings management level at manufacturing firms listed on the Indonesia Stock Exchange. This study also considers the moderating effects of investor protection on the relationship between the adoption of IFRS and earnings management levels. Thus, this study is expected to add empirical evidence regarding the impact of IFRS adoption on the earnings management level. The results of this study are expected to provide reference and expand the knowledges of management of earnings and financial accounting related to the Financial Accounting Standards and Investor Protection in Indonesia. It is expected to provide information for internal and external users about financial statements such as investors regarding the impact of IFRS adoption on earnings management practices in Indonesia and how investor protection moderates the impact of IFRS adoption on earnings management.

2 LITERATURE REVIEW AND DEVELOPMENT OF HYPOTHESES

The positive accounting theory, developed by Watts and Zimmerman (1960), describes the accounting policies and practices within the firm and predicts which policies should be selected by managers in certain conditions in the future. The existence of freedom for managers in determining accounting policies tends, according to the positive accounting theory, to encourage opportunistic behavior. Opportunistic behavior is an action undertaken by a firm when choosing a favorable accounting policy and maximizing its satisfaction (Scott, 2012, p. 395). According to Watts and Zimmerman (1990), there are three earnings motivation hypotheses linked by opportunistic behaviors conducted by the firm, namely the political cost hypothesis, debt agreement hypothesis, and bonus plan hypothesis. These hypotheses show that the positive accounting theory recognizes the existence of three relationships: (1) the relationship between management and owners; (2) the relationship between management and creditors; and (3) the relationship between management and the government (Anis & Imam, 2003).

Jensen and Meckling (1976) stated that agency relations are a contract between the management (agent) and the investor (principal). The emergence of earnings management can be explained by the agency theory from which managers know more internal information about the prospects of the firm than the owners (shareholders). The manager is obliged to provide information about the condition of the firm to the owner. The information can be provided through the disclosure of accounting information such as financial statements. In fact, financial statements sometimes do not convey accounting information that reflects the true state of affairs. This imbalanced information leads to the emergence of a condition known as information asymmetry, a situation in which there is an information gap between the manager and the firm's owner. Information asymmetry between the agent and principal can provide an opportunity for managers to conduct earnings management to mislead owners (shareholders) about the firm's economic performance.

The IFRS is an international accounting standard published by the IASB and is a global standard for preparing public financial statements (in IFRS FAQs). The objective of the IASC and the IASB in issuing IFRS is to develop a higher standard of financial statements, enhancing the transparency and comparability of financial reporting that will be widely accepted by countries around the world. Indonesia unifies its accounting standards to produce financial reports that have comparability in the international market.

Earnings management becomes one of accounting quality measurement attributes of information in this study because the performance measure is often used as the basis of business decisions in earnings generated by the firm. Scott (2012, p. 423) defines earnings management as the choice of accounting policies selected by managers to achieve specific objectives in the reporting of earnings. In the world of finance, an investor is a domestic or non-domestic individual agency that undertakes an investment in either the short-term or long-term. Protection of shareholder rights is very important because in many countries the expropriation of minority shareholders conducted by the controlling shareholders is very frequent. La Porte et al. (2006) explains the basic structure of the way investor protection is carried out through the Securities Law. In his research, he developed the measure of Securities Law and stated that there is a positive relationship between the Securities Law and the level of protection for other investors.

2.1 IFRS Adoption Impact on Earnings Management Level

The IFRS has the characteristics of a principle-based standard with steps to eliminate allowed accounting alternatives and requires a possible measurement for describing the firm's financial position (Barth et al., 2008). Another key characteristic brought by the IFRS is the use of fair value in measurement and more extensive mandatory disclosure. The adoption of a common set of accounting standards such as the IFRS improves the quality of earnings because management is under pressure to provide fair statements and to reduce involvement in earnings management practices (Houqe et al., 2012).

The earnings management evaluated in this study is measured by the discretionary accrual value, supported by Dimitropoulos et al. (2013) who provide empirical evidence of the IFRS adoption impact on the quality of accounting information in Greece. The measured quality relates to earnings management through discretionary accruals, timeliness of loss recognition, and relevance of accounting value. The results show that the quality of accounting information from these three measurements is better when using IFRS than when firms use local accounting standards.

Another conflicting study by Callao and Jarne (2010) found that the IFRS adoption of non-financial firms, listed in eleven equity markets in EU countries, actually improved earnings management. Based on this explanation, the first hypothesis in this study is:

H_1: IFRS adoption has an impact on the earnings management level

2.2 Investor Protection Moderates the Impact of IFRS Adoption on the Earnings Management Level

Palea (2013) argues that the impact of IFRS adoption may vary, depending on the institutional system of firms adopting it. One of the institutional systems that can create a different financial reporting quality in each country is investor protection system. Increased quality of accounting earnings depends on at least two factors: high-quality accounting standards and the protection of the country's overall investors (Soderstrom & Sun, 2007).

Through another cross-country study, Houqe et al. (2012) examined the effect of investor protection at the country level regarding the impact of IFRS adoption on earnings management in 46 countries. The results of the study found that earnings management will decrease when a country adopts the IFRS if accompanied by strong investor protection. The effect of investor protection in moderating the impact of the IFRS on earnings quality is also expressed significantly by Wardhani (2009). Therefore, the second hypothesis in this study is:

H_2: Investor protection moderates the impact of IFRS adoption on the earnings management level

3 RESEARCH METHODOLOGY

3.1 Research Approach and Variable Identification

This study uses quantitative approach done in a structured manner using quantified data that is generally studied through statistical analysis. This study uses explanatory research to discover the impact of IFRS adoption to earnings management and how investor protection moderates that interaction. Explanatory research explains the relationship between variables by using hypothesis testing (Sulistyanto et al., 2006, p. 14). This study uses IFRS adoption as an independent variable (X), earnings management as a dependent variable (Y), investor protection as a moderation variable (Z), and firm size (SIZE), firm debt (LEV), and firm growth (GWTH) as control variables.

3.2 Types and Data Sources

The type of data used in this study is quantitative. Secondary data required in this study includes: a list of manufacturing firms filed on the Indonesia Stock Exchange (BEI), between 2010 and 2015, obtained from www.sahamok.com; financial statements of manufacturing firms that have been audited and published by firms within the same period obtained from the official website of the Indonesia Stock Exchange (IDX); IFRS and Indonesian GAAP (SFAS); similarities and differences issued by PricewaterhouseCoopers for the period 2010–2015; data on investor protection measurement issued by the World Economic Forum (WEF) for the period 2010–2015.

3.3 Data Collection Procedures and Sample Selected

The data collection procedure used in this study is ‘documentation study’ and is carried out by collecting secondary data in the form of a financial report which becomes the research sample. The sample is then selected based on criteria using purposive sampling. It also determines the value of IFRS adoption refers to data on the IFRS adoption published by PricewaterhouseCoopers from 2010–2015 and determines the value of investor protection in reference to data measured by the World Economic Forum (WEF) period 2010–2015. Manufacturing firms listed on the BEI in 2015 totaled 143. However, only 68 firms per year can be sampled. The total sample of firms recorded in this study from 2010–2015 is 406.

3.4 Research Method

This study uses descriptive statistical analysis to explain the variables evident from the mean, standard deviation, variance, maximum value, and minimum value (Ghozali, 2013). This study uses the Moderate Regression Analysis (MRA) method to test hypotheses one and two. From the results of the analysis, the researchers will discover the extent of the impact of independent variables (IFRS adoption) to the dependent variables (earnings management) and evaluate the extent of the impact of moderator variables (investor protection) to the IFRS adoption of earnings management. The Moderate Regression Analysis method uses an analytical approach that maintains the integrity of the sample and provides a basis for controlling the impact of moderator variables (Ghozali, 2013). The classical assumption test is carried out before performing linear regression analysis, which comprises of a normality test, heteroscedasticity test, multicollinearity test, and an autocorrelation test. All testing is done by SPSS 20.0 software.

4 RESULTS AND DISCUSSION

The impact of the IFRS adoption on the earnings management level in this study is analyzed by using a t test which is generated using the MRA model. Based on the regression test results, it can be concluded that IFRS adoption has a negative effect and proved significant to earnings management. It is evident, based on the level of significance count 0.000 shows the significance level < 0.05. This suggests that hypothesis one, which states the IFRS adoption has an impact on earnings management level is supported.

In theory, the IFRS adoption will restrict the movement of management in creating earnings management and improving the quality of accounting information (Dimitropoulos et al., 2013). The adoption of a common set of accounting standards such as IFRS improves the quality of earnings because management is under pressure to provide fair statements and to reduce involvement in earnings management practices (Houqe et al., 2012). The results of this study prove that IFRS can suppress earnings management practices in accordance with research conducted by Dimitropoulos et al. (2013), which provides empirical evidence that IFRS adoption impacts on the quality of accounting information in Greece, subsequently reducing earnings. These results also indicate that the quality of accounting information is better when firms adopt IFRS rather than local accounting standards.

Based on the regression test result for hypothesis two, regression coefficients of investor protection as moderation variables equal to 0,150 with a level of significance 0,023 < 0,05; investor protection (INV) has proved to have a positive and significant impact on IFRS adoption regarding the earnings management level. It can be clearly seen that investor protection as a moderating variable can alleviate the negative impact of IFRS adoption on the earnings management level. These results indicate that the existence of investor protection can moderate (strengthen or weaken) the impact of IFRS adoption on earnings management level.

Rahmaningtyas and Farahmita (2015), supported by the study of Leuz et al. (2003), argue that the legal system can directly affect the quality of accounting through investor protection, in which opportunistic actions by management can be avoided if there is an effective legal regulation protecting the firm's external parties. The results of this study are in line with cross-country studies by Houqe et al. (2012), which examine the effect of investor-level protection on IFRS adoption relationships with earnings management, indicating that earnings management will be decreased when a country adopts IFRS accompanied by stronger investor protection. The results of this study also support the study by Hope (2003), which developed a comprehensive measure of accounting standards and suggested that strong investor protection and legal systems are fundamental determinants of high-quality financial statements.

5 CONCLUSIONS

This study aims to examine the negative impact of IFRS adoption on the earnings management level with investor protection as a moderating variable. Based on the results and analysis conducted using manufacturing firms listed on the Indonesia Stock Exchange during the period 2010–2015, it can be concluded that IFRS adoption negatively affects earnings management in manufacturing firms and proved to have a negative and significant effect. These results indicate that the IFRS adoption into local GAAP standards, in this case the PSAK, may reduce the earnings management level that may occur. Investor protection as a moderating variable can strengthen (moderate) the negative relationship between IFRS adoption and earnings management. These results indicate that investor protection assessed by the capital market law may reduce earnings management simultaneously with the adoption of IFRS.

In this study there are limitations that affect the results of the research, namely investor protection, which only use one measurement of capital market law and an index of investor protection according to the World Economic Forum (WEF). The results of this study are expected to provide reference and expand the knowledge of earnings management and financial accounting related to Financial Accounting Standards and Investor Protection in Indonesia and provide information to internal and external users' financial statements, such as investors regarding the impact of IFRS implementation on earnings management practices in Indonesia and how investor protection affects their relationship. In addition, this study is expected to be a reference for further studies on the application of IFRS to earnings management practices and how investor protection affects their relationship.

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