The Effect of IAS 32 and IAS 39 Adoptions on Earnings Quality: A Study of Banking Companies in Indonesia

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ABSTRACT

Earnings quality reflects the usefulness and relevance of earnings number. The quality is derived among others from the accounting standards used to develop the earnings figure. Indonesia's GAAP (called Standar Akuntansi Keuangan (SAK)) is undergoing convergence with the IFRS standards. Gradually, effective IASs and IFRSs are adopted into the SAK statements (Pernyataan Standar Akuntansi Keuangan or PSAK). One of the crucial IFRS standards is on Financial Instruments, namely IAS 32 and IAS 39.

This research focused on whether earnings quality differences exist with the adoption of IAS 32 and 39 towards earnings figure of banking companies. Earnings quality is measured using Modified Jones Model of earnings management. Thirty samples taken from the banking industry is examined. The research result failed to prove the existence of significant differences in earnings quality before and after the adoption of IAS 32 and 39. Thus the hypothesis is not supported. There are several reasons that the hypothesis is not supported. (1) It is suspected that the length of research is not long enough to capture the adoption process effectively; (2) the effective date of the adoption is too close with the adoption process; and (3) the nature and characteristics of companies may not encourage the use of international standards. Thus firms are not prepared to keep up with the change of standards.

Keywords: earnings quality, earnings management, and financial instruments.

1. INTRODUCTION

The world has come to the globalization era at the turn of the decade. Globalization occurs in all aspects including business. One of the indicators of business globalization is the increase in foreign direct investment (FDI). FDI is playing a larger and more important role in the world economy. According to World Investment Report published by the United Nations, there has been a significant increase in the flow of FDI in 1982 to 2007. Global sales of foreign affiliates were about 1.5 times as high as global exports in 2008 compared to almost parity in 1982 (Doupnik, 2012). Another sign of business globalization is the rise of multinational companies. The United Nations estimates that there are more than 82,000 multinational companies in the world, with more than 810,000 foreign affiliates. Increase in FDI as well as multinational

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companies trigger the increase of cross listing on foreign stock exchanges. As of 2010, there were 499 foreign companies from 47 countries cross-listed on the NYSE (Doupnik, 2012).

There are numerous problems that arise as a result of business globalization. One of the major problems faced by global firms is differences in accounting standards used by different countries around the world. Global companies must now convert and translate foreign financial statements to perform the consolidation process. Differences in accounting standards across countries also lead to another difficulty which is incomparability of financial statements and financial reports. This raises questions about the relevance and usefulness of financial information contained in those statements.

The accounting profession and standard setters have been under pressure from multinational companies, stock exchanges, securities regulators, and international lending institution to reduce accounting diversity and harmonize accounting standards and practices internationally. International Accounting Standards Board (IASB), as an international standard setting body, has developed International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). These standards can be adopted internationally.

Convergence of local generally accepted accounting principles (GAAP) with the IFRS standards has numerous advantages. Several of those advantages are the enhancement of financial statements' comparability, reducing financial reporting costs for cross listing, and raising the quality level of accounting practices internationally. Convergence enhances comparability of financial statements, which in turn will aid investors, namely international investors, in evaluating and assessing foreign securities. Convergence would also reduce financial reporting costs for companies that seek to list their shares in foreign capital markets since foreign markets are adopting the same standards. This will allow companies to gain access to less expensive capital in other countries. Due to the nature of the process of developing IFRS standards, it is believed that IFRS standards are of high quality. This means that convergence will lead to a higher quality of accounting practices.

There are studies that test the value of adopting IFRS standards in financial statements' information. Huifa Chen (2009) found a marginal increase in financial statement quality among European Union companies after the adoption of IFRS standard. Financial statement quality in this study is measured using magnitude of absolute discretionary accruals, accruals quality, managed earnings toward targets, and timely loss recognition. Marjan Petreski's study in 2006 evaluated the effect of IFRS adoption on Saint-Gobain Group's financial statement. It is found that the company's net income increased by 14.4% after the adoption. Petreski's study referred to another study made by Barth et al (2005). This study proved that companies have a lower level of earnings management and increase in value relevance in periods after the adoption of IFRS standards.

A characteristic of IFRS is principles-based standards. The US GAAP on the other hand is said to be rules-based standards. The nature of principles-based standards is that it relies on professional judgement. Besides professional judgement, many IAS and IFRS standards encourage the use of fair value and mark to market measurements. These two characteristics can lead to an increase in subjectivity in preparing financial statements. Subjectivity is not always

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negative. If it is trully based on professional judgement as well as using objective, independent measurement, IFRS will increase the quality of financial information.

Earnings have always been a focus of all investors. The use of IFRS standards can enhance earnings quality. As proven by several research (Huifa Chen, 2009 and Barth et al, 2005), earnings quality increases and earnings management decreases after IFRS adoption.

There has been an increase in the number of countries that converge to IFRS in the past several years. One of the countries in the process of convergence with IFRS is Indonesia. Indonesia's standard setting body is Ikatan Akuntan Indonesia (IAI). Indonesia's standard is called Pernyataan Standar Akuntansi Keuangan (PSAK). IAI takes the gradual approach in adopting IFRS which formally began in 2006. The body has announced to adopt effective IAS and IFRS as of 2009 by January 1, 2012. Initially, there was a three year gap between the IAS/IFRS standards with the adopted standards within the PSAK. The current gap between IFRS with PSAK is now one year.

Among the numerous IAS and IFRS standards that have been adopted into PSAK, the most intriguing standards are of financial instruments. They are IAS 32 and IAS 39. IAS 32 "Presentation and disclosure of financial instruments" is adopted into PSAK 50 (2006 revision), while IAS 39 "Recognition and measurement of financial instruments" is adopted into PSAK 55 (2006 revision). Before the adoption, the PSAKs afformentioned above were not based on IAS nor IFRS standards. These two IAS standards shifted the old paradigm of classifying, recognizing, measuring, and disclosing financial instruments. Indonesian companies were unprepared with the "new" concept of financial instrument. It leads to a question on whether Indonesian companies are able to execute to new accounting standards, given the nature of IFRS being principles based and using fair value. Will the quality of earnings be affected with the adoption of IAS 32 and IAS 39?

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Accounting Information, Earnings Management and Accounting Quality

Financial statements and financial reporting are the main sources of information used by investors, creditors, lenders and other user in making economic decisions. This information will assist users in making decisions related to providing funds to the issuer of the information. The information presented on these statements must have the characteristics of relevance and representational faithfulness in order to meet the objectives of financial reporting (FASB, 2008).

Financial statements are prepared based on generally accepted accounting principles (GAAP). The GAAP provides alternatives of treatments and measurement of financial transactions. The preparer (management) will choose among alternative method. The flexibility to choose from a set of accounting policies opens up the possibility of opportunistic behavior. This leads to earnings management (Scott, 2012).

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Earnings management is the choice by a manager of accounting policies, or rela actions, affecting earnings so as to achieve some specific reported earnings objective. With regards to freedom of accounting policies, there are two categories of accounting policies. The first is the choice of accounting policies per se, and the second is discretionary accruals. Included in the second category are provisions for credit losses, warranty costs, inventory values, and timing and amounts of low-persistence items such as write-offs (Scott, 2012).

The objective of a conceptual framework for financial reporting is to provide decision-useful information. High quality accounting information contains several qualities (FASB, 2008). Earnings management is one dimension of accounting quality. When firms perform earnings management, the quality of accounting information in financial reporting will be lower compared to those firms not managing their earnings. Thus earnings management affects earnings quality (Paiva, 2010).

Earnings quality is associated with the ability of the earnings number in estimating future cash flows as well as future earnings (Wibowo, 2009). Earnings quality is earnings which lacks perceived noise (Leisa Jang, 2007). The higher the perceived noise inherent in earnings, the lower the earnings quality.

2.2 The Association between IFRS Adoption and Earnings Quality

One of the advantages of convergence of an international accounting standard is to allow developing countries to have a high quality accounting standard. It is generally accepted that the quality of IFRS is higher than domestic accounting standards, especially in developing countries (Paiva, 2010). By adopting IFRS, it is expected that the quality of financial reporting, including earnings information, will increase.

Several studies provide evidence on the association between IFRS adoption and earnings quality. Tendenloo and Vanstraelen (2005) analyses earnings management of German firms that have adopted IFRS voluntarily. Firms audited by Big-4 firms have a decreasing level of earnings management. While it is also found that mere adoption of IFRS is not sufficient to guarantee a better quality of accounting information. Huifa Chen (2009) analyzed the accounting quality before and after IFRS adoption. It is found that the current version of IFRS has reduced allowable accounting alternatives, limited management's opportunistic discretion, and required accounting measurement and disclosure that can improve a company's financial position and economic performance. This leads to a higher quality financial statement.

Ismail *et. al* (2010) focused on the increased use of fair value within IFRS. The movement towards fair value accounting from historical cost accounting is expected to result in financial statements that are more relevant, timely, credible and transparent. Fair values are likely to reflect market values; and even in the absence of market value, determination of fair values normally involves independent appraisals. Thus, the quality of accounting information is enhanced.

2.3 Adoption of IAS 32 and IAS 39 into PSAK 50 and PSAK 55 and their Impact on Earnings Quality

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On January 1, 2010, PSAK 50 and PSAK 55 (2006 revision) is officially effective for banking firms. Prior to this date, the effective standards are PSAK 50 and 55 1998 revision. There are several major differences between the previous PSAK contents with the 2006 revisions which adopted IAS 32 and IAS 39, respectively. These differences are as follows.

Table 1. Major Difference of PSAK 50 and 55 Prior to and After Adoption of IAS 32 and 39

No.	PSAK 50 and 55 (1998)	PSAK 50 and 55 (2006)
1	Financial instruments are classified as (1) held-to-maturity (HTM), (2) available for sale (AFS), and (3) trading.	Financial instruments are classified into (1) assets and liabilities measured at fair value through profit and loss, (2) investments that are held-to-maturity, (3) loans and receivable, and (4) assets that are available-for-sale
2	Does not mention in detail the derecognition of financial instruments	Derecognition occurs only when the contractual rights towards future cash flows of the financial instrument has ceased or has been transferred by the owner. Transfer of financial assets has occurred if the risk and rewards of owning the asset has been transferred or if the entity no longer has control over the financial asset.
3	Initial recognition of all financial instruments is based on cost. Use of fair value is optional for those financial instruments classified as trading.	Initial recognition of all financial instruments are based on fair value
4	The standard provides disclosure requirements for AFS and HTM securities, which are a. information on the aggregate fair value b. unrealized holding gains or losses c. initial cost	The standard provides a more detailed disclosure requirement as follows: a. format and classification of financial instruments b. the company's risk management and hedging policy c. terms, conditions, and accounting policy d. interest risk e. credit risk f. fair value

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		g. and other information
5	Reclassifications of financial instruments are not ruled.	Reclassification of the following financial instruments are not allowed: a. reclassification from and to instruments measured at fair value through profit and loss (FVTPL) b. reclassification of loans and receivables from and to HTM and FVTPL c. reclassification of AFS to loans and receivables
6	Allowance for uncollected accounts is measured using the criteria ruled by Bank Indonesia.	Allowance is measured by using historical data of incurred loss in the last three year period.

The major differences above will affect the amounts reported on the financial statements and thus the quality of accounting. The use of fair value which is required by the "new" rule will enhance the relevance of the reported numbers compared to historical cost. Fair value is considered relevant compared to cost because it reflects current value and has more economical meaning than cost. Since the use of fair value has more economical meaning compare to cost, thus the accounting quality is better and better earnings quality. The new rule has a more rigid rule in reclassification of financial instruments. This will reduce management discretion that might lead to earnings management. Less management discretion will result in a lower earnings management level and thus a better earnings quality.

The revised PSAK also revised the method for measuring allowance for uncollectible. The previous PSAK uses the Bank Indonesia ruling on calculating allowance. This rule requires bank to calculate the allowance based on predetermined percentages on five categories: productive assets, special attention, not liquid, doubtful, and uncollectible. Management is free in classifying its financial instruments in to those five categories which leaves open room for earnings management. The revised PSAK requires the amount to be based on incurred credit losses in the past three years. It is based on actual past data which the manager is unable to change. This will lead to a less manager discretion and less earnings management, thus a higher earnings quality.

The last major difference in the revised PSAK is that it requires an extensive and detailed disclosure compared to the previous PSAK. The new rule requires risk management disclosure as well as credit and interest risks. This will lead to a transparent communication between the bank and its stakeholders. The more information that is mandated to be disclosed are proven to lower the level of earnings management because the manager feels that it is being closely monitored by its stakeholders (Halim, 2005).

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At last, based on the conceptual readings, previous studies, and the nature of the adopted accounting standard, it is hypothesized that earnings quality level after the adoption of IAS 32 and IAS 39 is different from that before the adoption.

3. DATA, VARIABLES, AND SAMPLES

This study uses financial statement data of banking companies listed on the Indonesian Stock Exchange (IDX) from years 2008 – 2011. Financial statement data are retrieved from IDX's capital market directory (ICMD) and the company's published financial statements if not found on the ICMD.

Earnings quality is determined by the level of earnings management. The lower earnings management level, the higher earnings quality. Earnings management is measured using the Beaver and Engel (1996) model of discretionary accruals. The model is said to be best suited for financial institutions (Rahmawati, 2007). The steps to calculate earnings management in this model follows.

$$NDA_{it} = \alpha + \alpha_1 CO_{it} + \alpha_2 LOAN_{it} + \alpha_3 NPA_{it} + \alpha_4 \Delta NPA_{it+1} + \varepsilon \quad (1)$$

Where NDA_{it} non-discretionary accrual for company i in year t CO_{it} is loan charge-offs bank i in year t, $LOAN_{it}$ is loans outstanding of bank i in year t, NPA_{it} is non-performing assets of bank i in year t, and ΔNPA_{it+1} is the difference between non-performing assets of year t+1 with non-performing assets of year t. First, all variables in the equation is deflated using the sum of book value of equity and allowance for doubtful accounts. The next step is performing a multiple regression to find α_1, α_2, α_3, and α_4 coefficients.

$$[DA_{it}] = TA_{it} - NDA_{it} \quad (2)$$

Where DA_{it} is discretionary accrual of bank i in year t and TA_{it} is allowance for loan losses of bank i in year t,. Earnings management occurs when $DA_{it} \neq 0$. The larger DA_{it} means the higher level of earnings management, in other words a lower earnings quality (Paiva, 2010).

The basic idea of this study is to learn whether the adoptions of IAS 32 and IAS 39 affected earnings quality. The earliest adoptions of these two standards are for the banking industry in Indonesia. This is ruled by IAI's statement number 1705/DSAK/IAI/XII/2008. That is why the samples taken for this study comes from the banking institution listed on the IDX. Since the effective date of adoption is January 1, 2010, the study will use two periods before adoption and two periods after adoption as the timeframe for data collection and analysis.

The sample selection is based on the following criteria:

1. The firm is a banking institution listed in IDX from 2007 – 2011.
2. The firm is a conventional banking institution. Syariah banking institution is excluded from the sample.

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3. The firm provides all the required data to measure earnings management or is attainable from other relevant sources.

Based on the criteria above, there are 30 banking institutions that were gathered and will be tested in this study.

To prove whether the adoption of IAS 32 and 39 have an effect on earnings quality, this study will perform a paired sample t-test of discretionary accruals two periods before adoption date with two periods after adoption date. The adoption date is January 1, 2010. This means that the study will observe financial statement from 2008 and 2009 (before adoption) and 2010 and 2011 (after adoption).

4. DATA ANALYSIS AND DISCUSSION

The following table shows the results of discretionary accruals (DA) during the study period.

Table 2. Discretionary Accruals

Bank	DA Before	DA After
AGRO	0.13030052	-0.01834219
BABP	-0.33362286	-0.17030044
BACA	0.19869753	-0.02383473
BAEK	0.09014607	0.07187386
BBCA	0.25035562	0.08568327
BBKP	-0.21150034	-0.00833592
BBNI	0.11624376	0.01311254
BBNP	0.13489288	0.21275684
BBRI	0.33219901	0.09515968
BBTN	-0.48342847	-0.53878832
BCIC	0.29423788	0.98439051
BDMN	0.00648163	-0.24212404
BEKS	-0.48256605	-0.13196626
BJBR	0.21727008	0.04539949
BKSW	-0.02592306	0.15196654
BMRI	0.11063730	-0.04797877
BNBA	0.16149079	-0.09239885
BNGA	0.05543190	0.05676257
BNII	0.15443993	-0.04128019
BNLI	0.02710196	0.00514464
BSIM	0.50483270	0.01977164
BSWD	0.06310519	-0.20135443
BVIC	0.38947228	0.08336338
INPC	-0.72617928	0.02021144

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MAYA	-0.25900111	-0.39881420
MCOR	-0.98249027	0.07615773
MEGA	0.08150641	0.01161124
NISP	0.14865815	0.05497491
PNBN	-0.09509980	-0.09843447
SDRA	0.15218164	0.08453636

The descriptive statistics for discretionary accruals follow:

Table 3. Descriptive statistics

	N	Minimum	Maximum	Mean
DA_before	30	-0.98249027	0.50483270	0.0006623997
DA_after	30	-0.53878832	0.98439051	0.0019641277
Valid N (listwise)	30			

It can be seen from Table 3 that the level of DA has increased after the adoption of the IAS standards. This is seen in the increase in mean, as well as the increase in the maximum DA after the adoption, even though the minimum DA is still lower before the adoption.

Before executing the statistical analysis to test the hypothesis, the normality test is done to know the normality of the compiled DA data. The Kolmogorov-Smirnov is used to test data normality. The result of the test follows:

Table 4. One-Sample Kolmogorov-Smirnov Test

		DA
N		60
Normal parameters[a,,b]	Mean	0.0013132637
	Std. Deviation	0.28611676193
Most Extreme Differences	Absolute	0.165
	Positive	0.138
	Negative	-0.165
Kolmogorov-Smirnov Z		1.278
Asymp. Sig. (2-tailed)		0.076

a. Test distribution is Normal.
b. Calculated from data.

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Since the data distribution is normal, the next step can be executed. The last test to be performed is testing the hypothesis using the paired sample t-test. The test results are on Table 5.

Table 5. Paired Sample t-test

	Paired Differences					t	Df	Sig. (2-tailed)
	Mean	Std. Deviation	Std. Error Mean	95% Confindence Interval of the difference				
				Lower	Upper			
DA_before - DA_after	-1.30E-03	3.326E-01	6.07E-02	-1.25E-01	1.23E-01	-0.21	29	0.983

The results show that the significant level of the test is 0.983, which is above 0.05. Thus the hypothesis is not supported. It is concluded that level earnings quality after the adoption of IAS 32 and 39 is not different from that of before the adoption.

The finding of this research is inconsistent with prior studies (Chen et. al, 2009; Ismail et. al, 2010; Petreski, 2006; Nikoomaram, 2010) which found a significant difference in earnings quality as an effect of IFRS adoption. There are several reasons that are suspected to result in the research finding. First, it is suspected that the survey period (two years after the adoption) is too short to effectively capture the effect of the adoption. According to IAI's pronouncement, the adopted PSAK 50 and 55 is mandated to be applied for banking firms on January 1, 2010. This study only used two years financial statement to test the hypothesis whereas previous research used three to five years after adoption to test the hypothesis. So, this is suspected to be too short to capture effective adoption of the standard thus the hypothesis cannot be supported.

The next reason which might cause the different result is the different settings of this study with previous ones. Previous research evaluated adoptions of IFRS in the European Union. As we know, EU has mandated the use of IFRS ever since 2005. Many companies in EU are multinational companies which have global consequences. On the other hand, Indonesia standards history did not root on international standards. It was a mix of US GAAP (prior to 1994), the Indonesian version of IAS (1994 – 2006), and then the IFRS convergence gradual adoption phase beginning 2006. So, in short, the EU companies have a more favorable understanding of IFRS than Indonesian companies. Compared to European capital market, the Indonesian capital market is still weak. Companies will focus on presenting financial statements for creditors and tax purposes when companies have weak-equity outsider financing (Nobes, 1998). Since Indonesian companies still rely on creditor financing, and stockholders are more concentrated compared to that of European companies, it might be that Indonesian companies are not encouraged to fully adopt IFRS at the present time.

Even though the statistical test was not able to support the hypothesis, there is an interesting finding based on the descriptive statistics. The average earnings management level is higher after

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the adoption of IAS 32 and 39. It means that there is an increase in the level of earnings management, or a decrease in earnings quality. It is possible that the flexibility in the principles based nature of IFRS coupled with the use of fair value measurements and a questionable competence of Indonesian banking managers, result in a higher level of earnings management. This is yet to be proven, though.

5. CONCLUSION

Based on the analysis and test of hypotheses, this study failed to prove differences in earnings quality of banking companies as a result of IAS 32 and 39 adoptions. Though insignificant in value, but the level of earnings management increased in the period after the adoption. In other words, the earnings quality decreased in periods after the adoption.

This research has several limitations. The first limitation is the number of periods (years) covered is only two years before and after adoption date. This is seen to be a very limited time frame to capture effectively the effect of standards adoption. Another limitation would be the small number of sample. Several data required to run the analysis were not able to be collected. As a result, several banks were omitted from the sample. The study only focused on IAS 32 and 39 adoptions towards banking companies. The results thereof might be different were other companies in the financing industry (such as insurance firms) were included in the sample.

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