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The Effect of Good Corporate Governance Mechanism to Earnings Management Before and After IFRS Convergence

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Abstract

This study aims to determine the effect of differences in the "Good Corporate Governance" (GCG) mechanism on Earnings Management, before and after Indonesian Financial Accounting Standards (PSAK) convergence IFRS, on the companies listed on the Indonesia Stock Exchange (IDX) in the year 2010-2013. The population in this study amounted to 136 manufacturing companies, where samples obtained was 65 companies in accordance with the sample selection criteria. GCG Mechanism is an independent variable that includes internal and external mechanisms. The study concluded that the effect of different GCG mechanisms to earnings management, depending on the proxy used for GCG mechanism.

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Keywords: Earnings Management, IFRS, Indonesian Financial Accounting Standards (PSAK), GCG Mechanism

1. Introduction

The fundamental difference between IFRS with a statement of financial accounting standards in Indonesia (PSAK) before convergence lies in the use of fair value, whereas PSAK prior to the convergence of IFRS using historical value in its calculations. Suwardjono (2005) "Fair value is the amount of Rupiah agreed to an object in a transaction between parties who wills freely without pressure or compulsion". Furthermore, the historical value is "historical boarding an agreement or rupiah exchange rates have been recorded in the accounting system". The use of historical

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cost is considered to be interrupted in the creative accounting practices such as earnings management and others. Because the preparation of financial statements based on historical cost does not reflect the real situation in the event of changes in purchasing power, so that the resulting financial statements are less able to reflect the real situation in case of price changes (Leng, Pwee. 2002). This will lead to inaccuracies and lack carefully situations of financial statements that are presented. Inaccurate financial reporting, can lead to errors in the delivery of information to stakeholders, and will eventually have a negative impact on the company itself.

Implementation of PSAK convergence to IFRS in Indonesia for a company that has been listed in the Indonesia Stock Exchange (BEI) is effective starting January 1, 2012 (Bapepam-LK, 2010). One such standard is PSAK 16 which regulates fixed assets. PSAK Before the convergence to IFRS, that is PSAK16, 1994 governing the treatment of fixed assets are measured according to historical cost, while after the convergence of IFRS, PSAK 16 revised according to IAS 16, fixed assets are measured at fair value (fair value). Changes in the use of historical value into a fair value will impact on the financial statements. The transition from historical cost to fair value on fixed assets required professional judgment by management as manager of the company. Improper of professional judgment will lead to errors in the presentation of financial statements and will affect the errors in decision-making by users of the financial statement, in this case primarily shareholders. This can occur because the not symmetric information between management and users of financial statements. To avoid this asymmetric information, the parties may appoint the principle that will help reduce this information asymmetry, to appoint an independent party control, which is reflected in the mechanism of Good Corporate Governance (GCG = GCG).

Research Ball et al. (2003) showed that high quality standards are not always produce high-quality information, but also related to the oversight function is a mechanism GCG. GCG role in monitoring is important in a company, GCG is one of the controls to achieve the company's management, the weaker of corporate governance is believed to be the main source of earnings management that is detrimental to stakeholders and ultimately the cause of the financial crisis. The financial crisis in various countries in 1997-1998, which begins in Thailand (1997), Japan, Korea, Indonesia, Malaysia, Hong Kong and Singapore which eventually turned into the Asian financial crisis, is seen as a result of weak practices of GCG in Asia, The argument underlying mechanisms of GCG effect on earnings management is when the company had established this mechanism, then there is the behavior of management to manage earnings will be reduced due to increased oversight and control with this mechanism. Nasution and Setiawan (2007) proved that the mechanism of GCG as measured by the composition of the board of commissioners negatively affect earnings management. Many of the standards set out in SFAS, but this study only focused on fixed assets. The reason is the management as an agent allowing for earnings management associated with discretionary management of the fixed assets, which one of them by changing the method of depreciation of assets. The application of PSAK convergence of IFRS is principle-based standards, causing the comparability of financial statements slightly decreased, especially when the use of professional judgment boarded with interest to regulate the profit, in the financial statements as an assessment of management performance.

The use of the accrual basis is superior than the cash basis for measuring performance and financial condition of the company. On the other hand the use of the accrual basis to provide flexibility to management in assessing and determining the accounting numbers. These conditions allow the management to beautify the financial statements by earnings management (Subramanyam et al, 2005). Earnings management is management intervention deliberately in the process of determination of the profits, usually to meet a personal goal (Schiper, 1989 in Subramanyam et al, 2005). This process is often done to beautify the financial statements, especially profit so that company stakeholders assess the company performs well. Several studies have shown that the application of IFRS in financial reporting can reduce earnings management. Theresia (2012) has done research in Indonesia and the result is that the practice of income smoothing decreased after conversion GAAP to IFRS, while other studies indicate that there is a significant difference between the level of earnings management before and after the adoption of IFRS. (Abhiyoga, 2013).

2. Literature Review & Hypothesis Development

Financial statements are prepared and used by management to accountability to stakeholders. Accountability is measured from the financial performance achieved by the management which is reflected on the profit - loss generated.