

## THE EFFECT ACCOUNTING CONSERVATISM USING LO\_EKO MODEL

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### ABSTRACT

The purpose research is to examine other variables that also affect the relationship between conservatism and earnings quality. Data population are companies listed in Indonesia Stock Exchange during the period 2014-2017. The sample selection is based on purposive sampling method with the purpose of obtaining a representative sample.

The results of this study indicate that the Instrumental Variables Conservatism has a significant positive effect on the Earning Quality. This means that management positively signals the application of accounting conservatism within the company and has an impact on improving the quality of earnings. The next investor is expected to provide more valuations by providing a high premium for the company's stock price.

**Keywords:** *Accounting Conservatism, Earning Quality, Equity Firm*

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## 1. INTRODUCTION

The practice of each company's conservatism is usually different, due to the various choices of accounting methods. Conservatism is an accounting principle that tends to generate profit and asset values. Conservatism slows revenue recognition and accelerates cost recognition. All substantive financial, operational or business variations can alter the views of rating agencies on the creditworthiness of a firm. This may lead to agencies to change the rating to assess the new level of credit risk. These variations may also alter the investors' views on the valuation and risks of the firm (Abad & Robles, 2014); (Aboulamer & Kryzanowski, 2016); (Adrian, Crump, & Moench, 2017). The results show the surrounding the application of the principle of conservatism. Conservatism critics argue that this principle causes the financial statements to be biased so it can not be used as a tool to evaluate corporate risk. Conservatism is the principle that most influence accounting valuation (Chakrabarty & Moulton, 2014)(Adewuyi, 2016)

Conservatism is defined as a concept that delays the recognition of future cash inflows and as a conservative accounting which states accountants report the lowest accounting information of several possible values for assets and revenues, and the highest for liability and burden (Kothari, 2014). Conservatism as a preference for accounting methods that yields the lowest value for assets and income on the one hand, and produces the highest value for debt and fees, in other words, the conservatism produces the lowest equity book value. Studying the links between fundamental signals and future earnings changes allows us to test directly the validity of the economic intuition that underlies the original construction of the signals.

Investors and creditors have different interests in the company. Investors are trying to take advantage by taking excessive dividends from creditor funds. This condition is made possible with companies with a very large managerial ownership structure. The decision to pay an excessive dividend increases. Meanwhile creditors want the security of funds for future profits. To avoid the transfer of profits made by investors through excessive dividend withdrawal then the creditor wants a conservative financial reporting. Emerging markets are accumulating capital at a faster rate than developed

markets, and their market capitalization and share in world capitalization is growing, but they lag far behind developed markets, such as the US and European markets, in terms of growth, number of stocks listed, foreign investment, liquidity, and risk. In a global portfolio, weight needs to be assigned to these markets to generate higher returns because of growth potential.

The extant literature suggests that these markets are informationally inefficient, and how that liberalization and trading infrastructure is necessary but not sufficient to improve the quality of information in EMs. As the EMs integrate with developed markets, the higher positive correlation exposes these markets to global shocks and volatility (Kumari, Mahakud, & Hiremath, 2017). A basic issue for understanding capital markets is whether limited attention affects the decisions of investors and equilibrium securities prices. A growing body of evidence confirms that attentional constraints affect investor trading (Hirshleifer, Hou, & Teoh, 2014). Conservatism supporters argue that conservatism produces higher-quality profits because this principle prevents corporations from exaggerating earnings and helps users of financial statements by presenting non-overstated earnings and assets. They prove that earnings and assets calculated by conservative accounting can improve the quality of earnings so that it can be used to assess the company. The presentation of changes in assets and liabilities of the company's long term issuer is seen by investors and capital market analysts as the company-specific risks that have an impact on asset pricing. This condition is caused due to the operational needs of the company with regard to the use of fixed assets in the machinery and equipment manufacturing companies considered important by investors (Ak, Dechow, Sun, & Wang, 2013); (Angelidis & Andrikopoulos, 2010) (Asri, 2017) (Amir, Einhorn, & Kama, 2013)

There are two differences in the information the manager has and the information on the profits of the entrepreneur. First is that managers have information about future earnings that investors do not have. Both investors are information that is reflected in stock price. Conservatism is part of an efficient

contract mechanism between the company and various parties. On the basis of the contractual explanation, accounting conservatism can be used to avoid moral hazard caused by parties with asymmetric information, limited time horizon, and limited responsibility. For example, a conservatism can withstand the manager's opportunistic behavior in reporting accounting measures used in the contract. Accounting earnings that are used as contract media will be more useful to reduce agency costs arising from moral hazard, if presented conservatively (Kwon, & Lee, 2017)(Vu, Chai, & Do, 2014)

## 2. LITERATURE REVIEW

The contractual relationships proxied with the ownership structure, debt structure, and firm size affect the accounting conservatism. In addition, these studies provide evidence of accounting conservatism practices in companies in Indonesia Accounting conservatism to deal with conflicts of interest around the dividend policy Researchers suspect that there are other variables that contribute to the relationship between conservatism and earnings quality. good Corporate Governance is a set of mechanisms that can protect the minority shareholders from expropriation by managers and controlling shareholders (insider) With an emphasis on legal mechanisms. The legal approach of corporate governance means that the key mechanism of corporate governance is the protection of external investors, both shareholders and creditors, through a legal system that can be interpreted by law and its implementation.

Of all the information about the company available throughout the year, some or more are derived from the income number of the year. The reported earnings quality can be affected by managerial share ownership. Managerial share ownership is one of the elements of Good Corporate Governance. We also find that the large-trader response to accruals information is restricted to cases where the previously announced earnings news for the quarter is non-negative. In other words, large traders seem to ignore the information in accruals following negative earnings surprises (Battalio, Lerman, Livnat, & Mendenhall, 2014); (Mendenhall, 2014); (Merton, 2010)(K. H. Kim & Kim, 2016)

The increase in operating current accrual changes being considered a specific risk reduction company. This is because the Indonesian capital market investors

more trading within a short time (Amir et al., 2013); (Arif, Marshall, & Lombardi, 2016); (Asri, Ali, Habbe, & Rura, 2017)

Based on the background of the problem that there are still pro and contra about the research about the effect of applying accounting conservatism to earnings quality. Researchers incorporate *good corporate governance* as a moderating variable, researchers want to obtain empirical evidence about the effect of accounting conservatism on the performance moderated *good corporate governance*.

### 3. RESEARCH METHODS

The population of this research is all public companies listed in Indonesia Stock Exchange during the period 2011-2017. The sample selection is based on purposive sampling method with the purpose of obtaining a representative sample in accordance with the criteria specified. Criteria companies sampled in this research are included in this type of manufacturing companies listed in Indonesia Stock Exchange during the period 2011-2017, published financial statements for the period ended December 31 during the observation period 2011-2017.

Independent variable is accounting conservatism as measured by the instrumental variable accounting conservatism (VIC) are made using 8 (eight) proxy that allegedly can catch construct conservatism based definitions accounting conservatism as a tendency to debase the value of assets, raising debt, recognizing revenue more slowly, and recognizes the costs more quickly. Alternative measures used accounting conservatism is an instrumental variable accounting conservatism (VICV) developed by Lo (Lo, 2005).

### 4. FINDINGS AND DISCUSSION

the predicted value of the dependent variable regression with LBKNBLPJ where independent variables INVRPDA, UDA, ULUDA, and DEPA.

Accounts receivable, namely abnormal Cross-sectional regression residuals Receivable (PD) on net sales change ( $\Delta Pjln_{jt}$ ) for firm j in year t, using

a total fixed assets as deflators (A) with the following formula:  $PD_{jt} / A_{it-1} = \beta1_{it} (1 / A_{jt-1}) + \beta2_{it} (\Delta Pjln_{jt} / A_{jt-1}) + \epsilon$

The study used reverse abnormal trade receivables (inv PDA) divided by total aktva year t-1 as a proxy for the level of accounting conservatism. Inv PDA calculated by multiplying the PDA to PDA to-1. INV PDA positive sign shows the organization of accounting knsrvatif and vice versa.

Preparations abnormal namely Cross-sectional regression residuals preparations (SDN) at cost of goods sold ( $\Delta KBD_{jt}$ ) for firm j in year t, using a total fixed assets as deflators (A) with the following formula:

$$SDN_{jt} / A_{it-1} = \beta1_{it} (1 / A_{jt-1}) + \beta2_{it} (\Delta KBD_{jt} / A_{jt-1}) + \epsilon$$

The study used reverse abnormal (inv SDA) divided by total aktva year t-1 as a proxy for the level of accounting conservatism. Inv SDA SDA is calculated by multiplying by -1. INV SDA positive sign shows the organization of accounting knsrvatif and vice versa.

Debt abnormal trade is cross-sectional regression residuals Payable (UD) in Cost goods sold ( $\Delta KBD_{jt}$ ) for firm j in year t, using a total fixed assets as deflators (A) with the following formula:

$$UD_{jt} / A_{it-1} = \beta1_{it} (1 / A_{jt-1}) + \beta2_{it} (\Delta Pjln_{jt} / A_{jt-1}) + \epsilon$$

The study used reverse abnormal trade debt (inv UDA) divided by total aktva year t-1 as a proxy for the level of accounting conservatism. Inv UDA UDA is calculated by multiplying by -1. INV UDA positive sign shows the organization of accounting knsrvatif and vice versa.

Normal Debt other than trade debts abnormal namely Cross-sectional regression residuals in addition to the debt Trade abnormal (UL-UD) on net sales change ( $\Delta PJLN_{jt}$ ) for firm j in year t, using a total fixed assets as deflators (A) with the following formula:

$$(UL-UD)_{jt} / A_{it-1} = \beta1_{it} (1 / A_{jt-1}) + \beta2_{it} (\Delta Pjln_{jt} / A_{jt-1}) + \epsilon$$

The study used the debt other than trade debts abnormal (UL- UDA) divided by total aktva year t-1 as a proxy for the level of accounting conservatism. UL UDA implementation of accounting is positive show conservative and vice versa. Components of normal debt is debt other than trade payables VAT, gifts debt, the debt commission, other yag contingent debt, and other fees that are unpaid.

Cost Depreciation and amortization abnormal namely Cross-sectional regression residuals Depreciation and amortization (DEP) on gross fixed assets (ATB ) for firm j in year t, using a total fixed assets as deflators (A) with the following formula:

$$(DEP_{jt}) / A_{it-1} = \beta1_{it} (1 / A_{jt-1}) + \beta2_{it} (ATB_{jt} / A_{jt-1}) + \epsilon$$

This study uses abnormal depreciation and amortization expense (DEPA) divided by total aktva year t-1 as a proxy for the level of conservatism accounting. DEPA positive sign shows the organization of accounting conservative and vice versa

### Descriptive Statistics

The sampling process generates 28 companies for research period 2014- 2017, resulting in 112 observations. To obtain an overview of the research data samples can be seen descriptive statistics such research in table 4.10 presents the descriptive statistics of data samples ( *data panel* ) in the period 2014 - 2017

Descriptive statistics					
variable	N	Minim	Maximu	Mean	Std. Deviat
Institusional	11	.27500	.97950	.753093	.17378429
Managerial	11	.00000	17.3100	.005020	1.9466299
Independent	11	.00000	.66667	.241881	.23462853
Audit	11	0	1	.51	.502
Conservatism	11	-0.61	0.33	0.11	0:15
Earning	11	-3682	2.608	.00000	.99639
Valid N	11				

Source: Appendix SPSS

VIC dependent variable showed an average of 0:1 to 0:15 while the standard deviation Earnings Quality variable as an independent variable has an average of 0.000 with a standard deviation of 0.996395. VIC dependent variable showed that the average standard deviation 0:11 to 0:15 .Variabel moderation proportion of institutional ownership represents the average deviation standar0 0 .7530938 with .17378429. The proportion of institutional ownership moderating variable indicates the average deviation standar0 0 .7530938 with moderation .17378429..Variabel Proportion Managerial ownership shows the average standard deviation 0.5020045 and 0. 1.94662991. Moderating variable proportion of independent commissioners showed the average standard deviation 0,2418813 and 0.23462853

Regression analysis serves to measure the effect of variable VIC against the quality of earnings. Therefore, before described a discussion of regression analysis, it first has to be presented the results of the regression data processed by using SPSS that can be seen through Table below.

Variable Regression Instruments Conservatism and Quality of Earnings

Model	unstandardized Coefficient		t <sub>count</sub>	Sig	Ket.
	B	Std error			
1. Constant	-0.475	0102	-3671	000	Significant
Conservatism	3,688	0593	6.053	0.00	
<b>R = 0.500</b>					
<b>R<sup>2</sup> = 0.250 Sig = 0,000</b>					

Source: Appendix SPSS

Based on the results table 7 regression data processing between VIC with earnings quality companies listed on the Indonesia Stock Exchange regression equation, it can be presented as follows: Earning Quality = - 0.475 + 3,688 VIC  
The regression equation above statistics can be translated as follows:

- a. The constant of -0.475 states that if VIC equal to zero (0), then the earnings quality is equal to -0.475. Accounting policy choices that are conservative cause the performance of the company to be ugly and ultimately have an impact on the financial statements produced by the company. If the company has a bad performance, the quality of the profit generated by the company is also ugly.
- b. VIC regression coefficient for states that every increase of 1% VIC, will improve the quality of the profit of 3,688.

The above test results show that conservative accounting policy choices significantly and positively impact on the quality of earnings because the value of  $p_{value} = 0.000$  less than the value of  $\alpha = 0.05$ . This means that VICt within the company. With the selection of accounting conservatism policies have an impact on the quality of the profit generated by the company to be qualified.



Determination coefficient analysis was conducted to determine how large the percentage of variation of the independent variables used in the model is able to explain the variation of the dependent variable. As the results of the model output summary in table 8, visible determination coefficient of 0.251 means that variations in the dependent variable earnings quality can be explained by variations in the independent variable of the audit committee only by 25%, and the rest of 75% is explained by other variables outside the model that are not included in the this analysis.

The determinant coefficient		
R	R Square	adjusted R
.500	.251	0,244

Source: Appendix SPSS

The sampling process generates 28 companies for research period 2014 to 2017, resulting in 112 observations. To obtain an overview of the research data samples can be seen as the study of descriptive statistics in Table 4.1 presents the descriptive statistics of data samples (panel data) from 2014 to 2017

The dependent variable quality of earnings as a proxy showed an average of 0.000 with a standard deviation of variables Instrument .986394 while conservatism (VIC) as an independent variable has an average of 0:10 with standar0.14 deviation. Moderating variable proportion of independent commissioners showed the average .2318812 and managerial ownership shows the average .005020045 which means most of the sample company shares not owned by the manager. Institutional ownership shows the average .7530938 which means most of the company's shares are owned by institutional sample.

Classic assumption test was not performed because this study uses panel data types that allow the identification of specific parameters without the need to make assumptions tight or do not require the fulfillment of all the assumptions of classical linear regression on *Ordinary Least Squar*( Adewuyi, 2016); (Bollerslev, Xu, & Zhou, 2017); (Nath & Brooks, 2017) (Borgers, Derwall, Coedijk, & Horst, 2017).

In testing this hypothesis figures *adjusted R-square* showed a value of 0.342, this means that 34.2% Earning quality can be explained by the independent variables in the model, while the rest is explained by other factors not included in the research model. Although the *adjusted R-square* value is low

but statistically significant models of 0.000 ( $<0.05$ ) with variable coefficients Instruments conservatism of 3,587. This means that based on the study sample, the variable accounting conservatism significant positive effect on firm value. Thus the first hypothesis which states that accounting conservatism positive effect on earnings quality is acceptable.

The results of this regression showed that based on the study sample, the variable existence of audit committee is moderating variables that can not be make accounting conservatism relationship with earnings quality. However, the marked positive coefficient indicates that the variable number of commissioners positive effect on accounting conservatism relationships with earnings quality. The structure of management in Indonesia as their *cross-directorship* (the connection between members of the audit committee company with another company audit committee members) may be able to weaken the function of service and control committee aud. If investor know that members of the audit committee of a company into another company official investors will give low ratings on the company. This is reasonable considering the conditions in Indonesia can be considered as collusion and nepotism which tends to be negative. However, this still requires further research. Another possibility requirements independent audit committee members and the educational background of finance and accounting as required by the regulations are not met. Thus  $H_{2d}$  hypothesis which states that the existence of an audit committee positive effect on accounting conservatism relationships with earnings quality, can not be supported.

## 5. CONCLUSION

From the results of research conducted at the manufacturing companies listed in Indonesia Stock Exchange that meet criteria for the selection of the sample, then a number of conclusions as follows:

The results of this study indicate that conservatism Instrumental Variables (VIC) positive and significant effect on the Quality of Earnings. This means that the management gives a positive signal about the application of accounting conservatism in the company and have an impact on improving the quality of earnings next. Investor expected to give more votes to give high premium to the

stock price of the company. The results of this study are consistent with research found a positive relationship between accounting conservatism with Ratings equity firm.

The results of this study also proves that the variable amount Comisioner independent board as one of the mechanisms of *corporate governance* is moderating variables that can make relationship between accounting conservatism with the quality of earnings and positive influence.

Instead proportion of managerial ownership, institutional ownership proportion and the existence of an audit committee is not a moderating variable that can make relationships accounting conservatism and earnings quality. The results of this study do not support the research find that audit committees positively influence the quality of earnings

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