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# FINANCIAL STATEMENTS CONSERVATISM EFFECT ON EARNINGS RESPONSE COEFFICIENT AND EARNINGS MANAGEMENT

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***Abstract:*** *The purpose of the study is to determine the effect of conservatism financial statement on earnings response coefficients and manufacturing companies earnings management. The research method uses analysis of Partial Least Square (PLS) with a software tool analysis SmartPLS 2.0 M3. The Object of research is amount of 57 unit manufacturing companies in Indonesia in the period 2007 to 2011. Based on the result of the research, the findings obtained as follows: conservatism financial statement proved a significant positive effect on earnings response coefficients and negatively on earnings management. Shown to significantly affect earnings management positively to wards earnings response coefficients. This study has implications both theoretically and managerially. For the theoretical implications, the study makes an important contribution in the development of the theory of conservatism financial statements, earnings response coefficients and earnings management. For the managerial implications, this research has implications for financial statement users making desicition not only based on accounting figures, but also need to look at earnings quality performance. Conservatism financial statement required to reduce opportunistic earnings management to improve earning quality as indicated by the increasing earnings response coefficient.*

***Keywords****: Financial Statement, Conservatism, Earnings Response Coefficients, Earnings Management*

## 1. INTRODUCTION AND LITERATURE REVIEW

Recently, conservatism financial statements is still an interesting phenomenon. Where ever, based on the International Financial Report Standards (IFRS) financial statements should be understandable, relevant, reliable and comparable without bias conservative. IFRS does not refer explicitly to the application of conservatism principle because it is not in accordance with the IFRS theory framework, but in fact the principle of conservatism on IFRS standards applied in the manner of conservatism while the consistent conservatism.

The application of IFRS is a manifestation above uniformity financial statements globally to improve reliable information and comparison system in thefinancial

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statements. International financial reporting standards ( IFRS ) implies that the principle of conservatism is no longer defined, but it does not mean going to disappear just because it was not specified in the standard. The principle of conservatism under IFRS is applied in a manner conservatism temporary (transient changes in accounting estimates as understated net assets through the creation of hidden reserves that can then be reversed) from the way of consistent conservatism (net asset valuation is too low). This has implications for financial statements users due to the effect of the application conservatism principle while (changed the accounting estimate) has a more complex level in the measurement of earnings compared to the consistent application of conservatism. When the principle of conservatism applied in a temporary way, the company conservatively treating some activities (items that do not meet the recognition criteria requirements or other probabilities), while others will be calculated in accordance IFRS. By treating this mixture accounting principles would also have implications for financial statements users.

Conservatism is an important conversion of financial statements in accounting, so called as the dominant accounting principles that most influence the accounting valuation (Sterling, 1967 Watts, 2003a), that the reason why the conservatism until now still have an important role in accounting practices. Conservatism is defined as a concept for delaying the recognition of future cash inflows (Watts, 1993), and as a conservative accounting is generally stated that the manager should report the lowest accounting information to assess the possibility of some assets and income, as well as the highest of several possible values liabilities and expenses (Hendriksen, 2002).

Conservatism is a financial concept that still in undivided controversial to date. Researchers who support the existence of conservatism is Lafond and Watts (2006). They argue that conservatism is expected to reduce the likelihood of management to manipulate the financial statements.

Watts (2003a), argues that conservatism is one very important characteristic in reducing agency costs and improve the quality of financial reporting information, and eventually will be able to increase the value of the company and its stock price. Ahmed *et al.,* (2002) as well as one of the supporters of conservatism conservatism found to reduce the conflict between bondholders and shareholders regarding the determination of dividend policy. While the cons researchers stating that increasingly conservative documented in the financial statements, the reported book value of equity will be biased (Monahan, 2009).

Such conditions indicate that those statements are less useful because it can not reflect the real value of the company . Conservatism into consideration indicated in the financial statements due to the activity of the company is covered by a uncertainty qualified. Certain quality profit also can not be separated from discretionary accruals (discretionary accruals) is contained in the earnings numbers. Discretionary accruals are accruals that can be controlled by management in the short term and can be used by management to adjust the desired amount of profit In large companies (go public),

one measure used to measure the relative earnings and stock returns is earnings response coefficients. Studies on the relationship between earnings and stock returns have been carried out . Earnings response coefficient is defined as the effect of one dollar earnings surprises on stock returns , and is measured as the slope of the regression of abnormal stock returns and earnings surprises (Cho and Jung, 1991).

Further more, earnings management is a way of presenting earnings adjusted to the desired destination by company managers. The most frequent manipulation is overstated earnings. This occurs because the profit (earnings) may reflect the operational performance of the company and a major concern for financial statements users in assessing a company. Given the opportunity to choose the use of several methods of accounting that there can be an opportunity for management to manipulate the financial statements of the so-called earnings management. Some studies indicate that accruals as the mechanisms used to manipulate earnings, associated with the use of accounting conservatism (Basu 1997; Givoly and Hayn 2000; Dumbar *et al.,* 2004).

Basu (1997) suggest that accounting conservatism is a practice that reduces profits (and lower net asset value) when responding to the good news. Therefore, one way that can be done to prevent the manipulation of financial statements is to choose a conservatism financial statement. Conservatism can restrict the actions that managers opportunistically manage earnings and take advantage of his position as a manager who has a lot more information than that outside parties (Gul *et al.,* 2002).

In Indonesia , a study conducted by Mayangsari and Wilopo (2002) and Dewi (2004 ) provide evidence that there is a relationship between accounting conservatism with earnings management . Mayangsari and Wilopo (2002) stated that the election of conservative accounting methods can not be separated from the interests of management to maximize its interests at the expense of the welfare of its shareholders, or commonly referred to as the agency problem (agency conflict).

Based on the descriptions above, the main problems in the study, as follows: Is the financial statements conservatism has positive effect on Earnings Response Coefficient? Is the financial statements conservatism has negative affect on Earnings Management? Is Earnings Management will have a positive influencing on Gain Coefficient?.

The purpose of this study is to examine and analyze the effect of conservatism on earnings response coefficients, the influence of conservatism on earnings management and the effect of earnings management on earnings response coefficients.

## 2. METHODOLGY

### Population and Sample

The population in this study are all listed manufacturing companies in Indonesia Stock Exchange (IDX) during the period 2006 to 2011. The selection of the sample using purposive sampling method with the sample criteria are manufacturing firms and

publish audited financial statements are consistent from 2006 to 2011, During the study period companies was not experienced delisted, stock split or reserve split.

**Method of Analysis**

The analysis model used in this study is a SEM component-based. Programs that used to run the program will be supported by Smart PLS (Partial Least Square) ver.2 M3. The selection was based on the consideration that softwareSmartPLS research model which consists of several independent and the dependent variable. Structural equation model is visualized in the following figure.

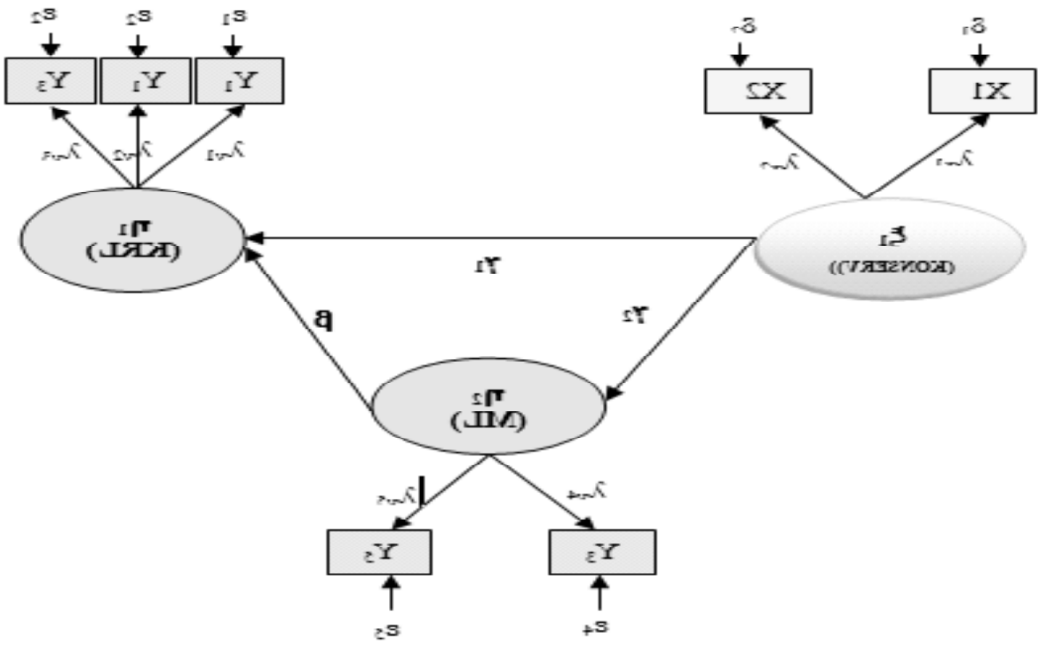

**Figure 1: Component-Based Structural Equation Models (PLS)**

*Note:*

$\xi_{11}$ = Financial Statement Conservation (Konserv)

$\eta_1$ = Earning Response Coefficient (KRL).

$\eta_2$ = Earning Management (ML)

## 3. RESULT AND DISCUSSION

Testing the measurement model and structural model testing.

Testing the measurement model includes two stages of testing the convergent validity and discriminates validity. The results of the validity of the output indicators shown in table 1 below.

**Tabel 1**
**Outer Loading (Mean, STDV, T-Value)**

| *Description* | *Original Sample (O)* | *Sample Mean (M)* | *Standard Deviation (STDEV)* | *Standard Error (STERR)* | *T Statistics (\|O/STERR\|)* |
|---|---|---|---|---|---|
| NI <- KONSERV | 0,9252 | 0,9010 | 0,1023 | 0,1023 | 9,0449 |
| CFO <- KONSERV | 0,9276 | 0,8614 | 0,2665 | 0,2665 | 3,4800 |
| CAR <- KRL | 0,7946 | 0,7767 | 0,2609 | 0,2609 | 3,0462 |
| EU <- KRL | 0,6368 | 0,5477 | 0,3091 | 0,3091 | 2,0601 |
| RT <- KRL | 0,6336 | 0,5823 | 0,1795 | 0,1795 | 3,5307 |
| TA <- ML | 0,9729 | 0,9613 | 0,0329 | 0,0329 | 29,5840 |
| NDA <- ML | 0,9836 | 0,9345 | 0,0968 | 0,0968 | 10,1652 |

*Source:* Run Smart PLS Bootstrappin

Based on Table 1 above shows the results of the PLS output Algorithm that the loading factor to construct conservatism, earnings response coefficients, and earnings management are high enough that all the above is required by or equal to 0.6 (≥ 0.6) that conditioned.

Smart PLS output Bootstrapping results show that the value of t statistic for correlation between the indicators to construct conservatism, earnings response coefficients, and earnings management is above all that is required is 0.2 (t statistic> 0.2), so obviously all indicators have significant validity. Results of construct reliability conservatism, earnings response coefficients, and earnings management has a value of composite reliability> 0.70, Cronbach alpha value> 0.70 and AVEAVE value> 0.50.

Thus the entire construct can be expressed reliable.

Discriminant validity testing, performed by using the value of cross-loadings. The results of cross loadings output indicators to construct conservatism, earnings response coefficients, and earnings management was seen that the correlation between NI and CFO is higher with KONSERV construct compared with other construct. Similarly, the indicator CAR, EU and RT has higher correlation with KRL construct as well as TA and NDA correlation value is higher with the indicator ML compared construct with other construct. Based on the test results it can be said that any correlation between the indicators with it's construct have good discriminates validity.

Structural models testing include significance testing track relationship,

R2, Effect Size f2, and the Stone-Geisser Q Square test (Q2). Financial conservatism reporting and earnings management is able to construct variability earnings response coefficients of 14.02%, while conservatism financial statements can explain the variability of earnings management construct of 6.06% seen in Table 2. Referring to Chin (1998), this value is included in the weak category.

**Tabel 2**
**R Squre ($R^2$)**

| | *AVE* | *Composite Reliability* | *R Square* | *Cronbachs Alpha* |
|---|---|---|---|---|
| Konservatisma (KONSERV) | 0,8582 | 0,9237 | 0,0000 | 0,8347 |
| Koefisien Respon Laba (KRL) | 0,7795 | 0,8320 | 0,1402 | 0,7770 |
| Manajemen Laba (ML) | 0,9570 | 0,9780 | 0,0606 | 09558 |
| | *Effect Size* $f^2$ | | | *1-SSE/SSO* |
| Konservatisma (KONSERV) | 0,071 | | | 0,0499 |
| Manajemen Laba (ML) | 0,008 | | | 0,0036 |

*Source:* Run XLSTAT2013, Smart PLS Blindfolding.

In Table 2 above the value of the effect size $f^2$ of 0.071 KONSERV construct and $f^2$ value construct ML effect size of 0.008, indicating that the effect size $f^2$ KONSERV construct and ML construct, when there is or is not in the category model of small structural level in order to evaluation the predictive power of the model using exogenous latent construct Stone's-Geisser Q2 (Q2 predictive). Based on the results index construct cross validated redundancy, to conservatism construct (KONSERV) and earnings management (ML) is still greater than 0, means 0.0499 and 0.0036, indicating that the latent conservatism construct and earnings management has predictive relevance is still better to latent construct earnings response coefficients (KRL). Value Goodness of Fit (GoF) of 0.2696 indicates that the combined performance of the model fit into the category of moderate towards large.

## Hypothesis Testing

**Table 3**
**Path Coefficients of Conservatism Construct with KRL**

| *Description* | *Original Sample (O)* | *Sample Mean (M)* | *Standard Deviation (STDEV)* | *Standard Error (STERR)* | *T Statistics (\|O/STERR\|)* | *R Square* |
|---|---|---|---|---|---|---|
| KONSERV -> KRL | 0,3389 | 0,3417 | 0,2103 | 0,2103 | 3,6113 | 0,1162 |
| KONSERV -> ML | -0,2264 | -0,8884 | 0,1219 | 0,1219 | 2,8165 | 0,0606 |
| ML -> KRL | 0,1390 | 0,1561 | 0,2861 | 0,2861 | 2,1358 | 0,0240 |

*Source:* Run XLSTAT2013, Smart PLS blindfolding.

The first hypothesis (H1) states that the conservatism level of financial reporting positive effects on earnings response coefficients. As Seen in Table 3 above, that conservatism financial statements (KONSERV) with earnings response coefficients (KRL) has Tstatistic value (3.6113)> 2. It can be concluded that the conservatism of financial statements (KONSERV) shows positive and significant effect on earnings response coefficients (KRL) or **H1 is accepted**. R-square value of the variable conservatism financial statements (KONSERV) on earnings response coefficients (KRL)

sebesar11, 62%, while the remaining 88.38% is explained by other variables outside of financial conservatism statements (KONSERV) were studied. The results of the above analysis shows that the level of conservatism in the financial statements of manufacturing companies have an in weak fluency on earnings response coefficients with a contribution of 11.62% is included in the category (low), but the overall measurement model and structural testing refers to the Goodness of Fit (GoF ) is still in the moderate category. Thus, conservatism financial statements using the accrual basis net income before depreciation and amortization with operational cash flowin a manufacturing company is still relevant react to the stock market.

So the results of this study will support and complement the research conducted by Giner (2001) that stated bad news has a greater impact than the price of a security over the new good. Then, also support the study done in Indonesia by Mayangsari and Wilopo (2002) using the C-Score as a proxy for conservatism proves that conservatism has a relevance value, so that the companies financial statements that apply the principles of conservatism may reflect the market value of the company. Clearly, based on the results of this study and the two others previous studies conducted show that conservatism with different proxies continued to show a reaction to the market or the market value of the company.

The second hypothesis (H2) states that the level of conservatism negatively affect on earnings management. Based on table 3, the obtained degree of financial statements conservatism (KONSERV) with earnings management (ML) has a coefficient number of -0.2264 parameters and statistical values of 2.8165 T > 2 it can be concluded that the financial statements conservatism (KONSERV) and has a significant negative effect on management earnings (ML) or **H2 could be accepted**. Substantial direct influence conservatism financial statements (KONSERV) on earnings management ( ML ) is equal to -0.226 .

This suggests that the increasing financial statements conservatism (KONSERV) especially with the high level of operating cash flow (CFO) of the company, will be able to lower earnings management (ML) , especially with the high level of non-discretionary accruals (NDA) conservatism manufacture. R2 variable company financial statements (KONSERV) on earnings management (ML) of 0.0606 , which means that the earnings management variables (ML) can be explained by the conservatism of financial statements (KONSERV) of 6.06%. Referring to the results of the testing/ evaluation of structural conservatism suggests that the influence of the financial statements on earnings management in manufacturing companies fall into the category of weak (low) , but the overall measurement model and structural testing refers to the Goodness of Fit (GoF) is still in the moderate category Thus conservatism financial statements using the accrual net income method before depreciation andamortization with operational cash flow in manufacturing companies give a negative reaction to earnings management using discretionary accrual proxy which represents the difference between total accruals and non

discretionary accrual in manufacturing companies conducted by the accountant managers.

The results are consistent with Watts (2003) which states that the accounting conservatism arises from incentives associated with the cost of the contract, taxes litigation and politics that are beneficial for the company to reduce agency costs and reducing excessive payments to the parties such as managers, shareholders , the courts and government. In addition conservatism also led to understatement of the earnings in subsequent periods, as a result understatement of the cost for the period. Similarly, the results of this study in line with the statement Basu (1997) which states that conservative accounting as the accounting practices that reduce profits in response to bad news, but did not increase earnings in response to good news.

The third hypothesis (H3) states that the positive effect of earnings management on earnings response coefficients. Based on Table 5 above can be seen that earnings management (ML) with earnings response coefficients (KRL) has a coefficient of 0.1390 and the value parameters T statistic of 2, 1358> 2 it can be concluded that the earnings management (ML) effect on earnings response coefficients (KRL ) or **H3 is accepted.** The major direct effect of earnings management (ML) on earnings response coefficients (KRL) is equal to 0139. This suggests that increasing the amount of earnings management (ML), especially with the high level of non-discretionary accruals (NDA) then the company will be able to increase earnings response coefficients (KRL), especially with the high level of cumulative abnormal returns (CAR) manufacturing company. R-square value of earnings management variables on earnings response coefficients at 2.40%.

The results of the above analysis suggests that earnings management in manufacturing firms has a positive effect on corporate earnings response coefficients. Referring to the results of the testing evaluation showed that the structural effect of earnings management on earnings response coefficients in manufacturing. So the Earnings Management using discretionary accrual proxy which represents the difference between total accruals and non discretionary accrual at manufacturing companies that are still relevant to provide a reaction to the stock market.

Based on the results of the above research hypothesis testing, manufacturing companies reported positive earnings means that the income is greater than the burden on / companies and firms reporting negative earnings means the opposite, namely that the load is greater than the revenue the company does not have a positive value in the investors perception related to changes in stock prices the company.

The results are **consistent** with the opinion of Lipe (1990) that earnings have low predictive power less useful in predicting future earnings so that earnings response coefficient generated will be low.

## 4. CONCLUSION

1. Financial Statements Conservatism being proxy by the difference between net income before depreciation and amortization to operating cash flow in a

manufacturing company and a significant positive effect on corporate earnings response coefficients to the substantial effect of 0.339. This empirical finding is consistent with the research hypothesis which states that the financial statements conservatism positive effect on corporate earnings response coefficients.

2. Financial Statements Conservatism being proxy by the difference between net income before depreciation and amortization to operating cash flow in a manufacturing company and a significant negative effect on earnings management company with the influence of -0.2264. This empirical finding is consistent with the research hypothesis which states that the financial statements conservatism negatively affected company earnings management.
3. Earnings management being proxy by discretionary accrual value which represents the difference between total accruals and non discretionary accruals in manufacturing companies and a significant positive effect on corporate earnings response coefficients to the substantial effect of 0.1390 . This empirical finding is consistent with the research hypothesis which states that the positive effect of earnings management on corporate earnings response coefficients,.

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