

## ***The Value Relevance of IFRS Adoption in Indonesia***

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### **ABSTRACT**

Pros and cons of the benefits of IFRS adoption have become an ongoing debate following the inconclusive results of prior studies. Whether IFRS increase value relevance of accounting information or not, especially in developing countries is an interesting and relevance research question. Indonesia as one of the developing countries that committed to adopting IFRS has an interest in obtaining empiric evidence on the value relevance of accounting information after nearly five years of IFRS implementation. This study aims to fill the need to enhance adopters' compliance with the standard. Ohlson Modified Model (1995) is used to test the value relevance of accounting information. Using longitudinal data of listed manufacturing companies in Indonesia Stock Exchange (IDX), this study confirms that value relevance of accounting information increase after IFRS adoption than before adoption. The results robust using Pooled Least Square and Random effect model.

**Keywords:** IFRS adoption; value relevance; accounting information; stock prices.

### **INTRODUCTION**

Unlike the US GAAP which rely on rule-based and historical cost, IFRS as a new standard focus on principle based and fair value. The proponents of IFRS argue that this standard provides more value relevance than the old one [2]. Accounting information has a value relevance when this information can influence investors to revise their prior decision on firm value [29].

IFRS is aimed to increase the information content of financial reporting, to reduce reporting lag and to enhance the foreign investment inflows [35]. Further, the adoption of IFRS is also expected to enrich transparency and value relevance of financial information [39;47]. Besides its proposed benefits, the adoption of IFRS is costly. The costs include the cost of implementation, training costs, IT investigation, audit fee, renegotiation of debt and others [14]. The costs of IFRS adoption are expected to be less than the benefits.

A number of studies on IFRS adoption have been conducted in developed countries [9; 28; 36; 43; 27; 56; 38; 50; 5; 45; 13; 17; 4; 18; 47; 1; 41; 10], with positive result. [16; 6] find negative result. However, the results did not entirely support the notion that IFRS adoption increases value relevance.

Current studies in developing countries also show conflicting results. Some studies suggest that IFRS adoption increase value relevance [7; 29; 24; 8; 31; 39; 59; 46]. While other studies uncovered the opposite finding. They found negative associa-

tion between IFRS adoption and value relevance [30; 58]. The varying results have to lead to sharp debates among researchers whether IFRS adoption augments value relevance or not.

As one of the developing countries and the member of the G20, Indonesia has committed to convergence to IFRS starting in 2012 [23]. The significant changes of accounting standard can alarm for some parties, including managers and investors since the cost of adoption is very high. It is essential to adopters in Indonesia to grasp the benefit of the passage. Unfortunately, research on the value relevance of IFRS adoption in Indonesia is very rare. A survey that related to IFRS adoption in Indonesia [33] only focus on the association between IFRS and earning quality and does not specifically investigate the value relevance of the passage. The benefit of IFRS adoption is important to be examined to promote the compliance of the standard since there is no direct incentive promised to the adopters.

Moreover, in Indonesia, it is the right time to begin examining the benefit of IFRS adoption after its five years of implementation. Prior research only investigated several years before the passage. Therefore, the results did not pertain to the value relevance of IFRS adoption.

To overcome the inconsistency of prior results, this study will compare several years before and after adoption. The usage of longitudinal data in this study helps to capture the changes over time and among firms.

This study is also the first in examining value relevance of IFRS adoption in Indonesia using longitudinal data. Unlike prior studies that try to grab all benefits of IFRS adoption in one study, this research focuses only on the value relevance of passage according to the aim of the issuing of IFRS itself. Therefore the results are expected to contribute to study on IFRS adoption in developing countries that so far is very rare, and its results are still inconclusive.

### The Development of Accounting Standards in Indonesia

Indonesia has a series of financial reporting standard development. It was started from period 1973-1984 when Indonesia Institute of Accountant (the IAI) established the accounting standards that known as Indonesia Accounting Principles (IAPs). In 1984, these rules were revised to be IAPs -1984. At the end of 1994, The Committee of IAPs started with the numerous revision of accounting standards and resulting 35 pronouncements which majority of them in line with International Accounting Standards published by International Accounting Standard Board (IASB). Since 1994 until 2004, there was a significant change in platform, where Indonesia Accounting Standard Setter moved from US GAAP platform to International Standards platform [51]. There is a substantial difference between both standards, the first one focus on rule-based and historical cost, while the rest uses principle-based and fair value.

Early in 2004, the convergence of IFRS has become a commitment for Indonesia. The Financial Accounting Standard Setter (DSAK) under IAI has played a significant role in promoting IFRS convergence among G20 members especially in South East Asia [23].

The stages of IFRS convergence begin with the adoption stage of 2008-2010, the preparation stage in 2011 and the implementation stage in 2012. However, many firms have initiated to voluntary adopted earlier. Therefore in this study, we used 2011 as the cut off year for post-adoption.

### Value Relevance

To accommodate the need for relevant information, IFRS has focused on fair value approach. The using of this method is expected to be responded by the market through the changes of stock prices [21]. IFRS adoption will produce competent financial reporting thus increasing its value relevance [39; 2]. Value relevance refers to the capability of accounting information to portrait the firm value, so that is capable of making investors

revise their prior decisions [15]. The changes of investors' choice are represented in the variations of stock prices. The higher the association of accounting information and stock prices, the higher the value relevance of accounting information [3]. Accounting information will be considered to have a value relevance when stock prices fluctuate due to the report [20].

This study bases on Ohlson model (1995) in measuring value relevance of accounting information. This is done by investigating the association of information content of accounting earning, i.e., earning per share, book value per share and stock prices, using the following model:

$$P_{i,t} = \alpha_0 + \alpha_1 BV_{it} + \alpha_2 EPS_{it} + \alpha_3 CFOS_{it} + \varepsilon_{it} \quad (1)$$

Where:

BV = book value of equity firm i, year t

EPS = earning per share firm i, year t

CFOS = cash from operating per share firm i, year t

The statistical association between accounting information that proxied by EPS, BVPS or CFOS, and *stock prices*, imply the existence of value relevance [53]. According to [44] accounting earning has *value relevance* if it was capable of altering stock prices. The variation of stock prices as a representation of investors' response.

### IFRS Adoption and Value Relevance

*Value relevance* shows the level of association between accounting information and stock prices, the higher the level of relationship means the higher the value relevance of the report [3; 15]. Accounting information has value relevance if stock prices react over the data [20;37].

Accounting information compiled under IFRS will better describe the current state of firm value and has a higher level of comparison. Thus the transparency and the comparability of financial reporting increase for firms that adopt IFRS. Once the transparency increase, the information asymmetry between internal and external parties such as managers and owners, majority and minority investors will reduce. Investors value the lower estimation risk of companies and thus reduce the cost of capital. On the other hand, the improvement of comparability makes easier for investors to compare performance among businesses and worldwide. Investors' confidence over the accounting information increase. Further, it will influence investors' decisions as reflected by the changes in stock prices. When accounting information affects the investor response, the accounting information has value relevance.

It is expected that post-adoption IFRS will have more value relevance accounting information than pre-adoption. It also has been supported by some prior researchers, among others are [8; 29; 24; 7; 31; 39; 59]. They documented that the value relevance of accounting information increase after IFRS adoption, it means that there was a higher association between accounting information and stock prices in post-IFRS adoption. Therefore, this research proposes the following hypothesis:

H1: There was an increase of value relevance of accounting information in post-IFRS adoption.

## RESEARCH METHODS

This study predicts that there is an increasing of the value relevance of accounting information after IFRS adoption. To test the hypothesis, this study assesses the value relevance of accounting information four years before passage (2007-2010) and four years after adoption (2011-2014) using modified Ohlson Model (1995), then compared  $R^2$  of pre and post adoption. If  $R^2$  after adoption increase and the model fit, in which prob-F or prob-Chi2 less than 0,1 or 0,05, the hypothesis is confirmed. The value relevance is measured by the level of association of accounting information and stock prices. Three proxies represent accounting information are earning per share (EPS), book value equity per share (BVPS), and cash flow from operating per share (CFOS). Stock prices are the average ten days of stock prices after three months of the publication date of financial reporting.

EPS indicates net income available for common shareholders. It obtains from net income fewer dividends on preferred shares scaled by the weighted average of common stock outstanding [13]. BVPS refers to total equity scaled by weighted average outstanding share [5]. While CFOS is cash flow from operating scaled by weighted average common share outstanding.

The sample is selected using the following criteria; (1) firm listed in Indonesia Stock Exchange since 2007, (2) staying at public companies for the period 2007-2014 and (3) has adopted IFRS since 2011. The sample in this research is all manufacturing companies. 60 firms in each sample group qualify the criteria. In total, we have 480 firm-year in both sample groups. The source of accounting and stock prices data are from Bloomberg and YahooFinance.

## RESULTS

Profile of variables of each of sample groups (pre-adoption, post adoption and total) are presented in table 1 and 2, as follows.

**Table 1.** Pairwise Correlation

	EPS	BVPS	CFOS	SPRICE
EPS	1,0000			
BVPS	0,9029 ***	1,0000		
CFOS	0,5364 ***	0,6087 ***	1,0000	
SPRICE	0,9328 ***	0,8911 ***	0,4976 ***	1,0000

The table shows a significant correlation between independent variables of EPS and BVPS to the Share price.

**Table 2.** Mean Difference between Pre and Post Adoption

	Pre Adoption	Post Adoption	Total Sample	t-test
EPS	68,853	116,548	944,599	- 1,878 **
BVPS	574,423	954,031	764,227	- 2,495 ***
CFOS	79,384	86,903	83,143	- 0,312
SPRICE	954,265	2.110,971	1.532,618	- 2,345 ***
Obs	240	240	480	

## Selection of the Best Model

To determine the best model of panel data of each of sample groups, Chow tests, and Hausman test is applied. From the Chow test of pre-adoption data known that fixed effect is more appropriate since p-value is less than 0,1, therefore  $H_0$  that stated the best model is Pooled Least Square (PLS) is rejected and the fixed effect is the more suitable model. Subsequently, Hausman test is applied to decide whether the fixed effect or random effect is the best model for pre-adoption panel data. The result shows that  $H_0$  stated that model is fixed effect model cannot be rejected. Therefore fixed effect is verified as the best model for pre-adoption panel data. Summary of the test of data panel is presented in table 3.

Table 3 indicates that EPS and BVPS consistently prove as the significant influence on stock price, while CFOS as an additional variable in modified Ohlson model (1995) does not show the same results. Overall,  $R^2$  of all model either PLS, fixed effect or random effect model is very high. It supports that the value relevance exists in accounting information.

The results of post-adoption panel data arrive the same conclusion with the pre-adoption test in which fixed effect model proved as the best model. The results are robust either tested with PLS and random effect model, although they are not selected as the best model. Both model still have high  $R^2$ . It indicates that value relevance exists in accounting information.

**Table 3.** Summary of PLS, Fixed Effect, and Random Effect Tests-Pre Adoption

	PLS		Fixed effect		Random effect	
	Coef	t	Coef	t	Coef	z
EPS	12.081	12.570***	1.486	1.480	11.256	11.330***
BVPS	0.674	3.530*	8.496	15.730***	0.910	4.150***
CFOS	0.520	0.860	-0.142	-0.300	0.712	1.190
Const.	-305.930	-2.610**	4016.909	-15.380***	-440.213	-2.430**
Adj R-sq						
between			0.812			0.605
within			0.849			0.926
overall	0.818		0.709			0.819
F	359.900		254.000			706.210
Prob-F	0.000		0.000			0.000

**Table 4.** Summary of PLS, Fixed Effect, and Random Effect Tests-Post Adoption

	PLS		Fixed effect		Random effect	
	Coef	t	Coef	t	Coef	z
EPS	14.439	14.560***	1.829	2.290***	8.630	7.960***
BVPS	0.955	5.590***	-1.531	-8.750***	1.039	5.080***
CFOS	-1.559	-2.760***	-0.793	-2.910***	-0.952	-2.030**
Const.	-347.982	-2.410**	4016.909	-15.380***	-196.703	0.580
Adj R-sq						
between			0.359		0.012	
within			0.825		0.950	
overall	0.910		0.762		0.908	
F	810.360		32.970		291.280	
Prob-F	0.000		0.000		0.000	

**Table 5.** Hypothesis Testing

	Post Adoption		Pre Adoption	
	Coef	t	Coef	t
EPS	0,229	4,130 ***	0,115	2,300 **
BVPS	0,186	1,060	1,544	6,170 ***
CFOS	0,056	1,320 **	-0,051	-0,890
Const.	4,425	4,190 ***	-3,194	-2,370 **
Adj R-sq				
between	0,186		0,387	
within	0,711		0,493	
overall	0,625		0,512	
F	8,290		23,400	
Prob-F	0,000		0,000	

$R^2$  of each of model seems higher than the pre-adoption data, but the conclusion cannot be drawn from this model since fixed effect model has heteroscedasticity problem that needs to be fixed first.

### Heteroscedasticity Test

The common problem in fixed effect model is heteroscedasticity; therefore this issue should be mitigated. Breusch-Pagan/Cook-Weisberg test for heteroscedasticity applied to detect heteroscedasticity and the results show that prob-chi2 of fixed effect model for both pre and post adoption less

than 0,05. It means that heteroscedasticity exists in both models. To overcome this problem, data is converted into logarithmic. The results of heteroscedasticity tests after data transformation prove that the issues have been mitigated as indicated by the value of prob-chi2 for both models is higher than 0,05.

After the heteroscedasticity problem mitigated, data is rerun using fixed-effect model. The results of fixed effect model for both pre and post adoption are as follow (Table 5)

## DISCUSSION

IFRS adoption is intended to increase transparency and comparability of accounting information [47; 39]. Higher quality of accounting information will improve the investors' confidence in financial reporting since the reports convey information about the firm value to the investors. This study using longitudinal data exhibits that accounting information has information content, and as predicted,  $R^2$  in post-adoption is as 0,625 greater than pre-adoption that only has 0,512. It means that the value relevance of accounting information increase after IFRS adoption. This finding consistent with some prior research especially in developing countries [7; 29; 24; 8; 31; 39; 59; 46]. The regulation of the Indonesia Standard Setter that mandate firms adopt IFRS remind the ques-

tion of its benefits. This results can answer the doubts and motivate firms to comply with the standard since the benefit justifies it.

In developing countries like Indonesia with characterized by low investors protection and weak law enforcement, the mandatory of IFRS adoption acts as a new tool to increase the confidence of investors and other users on financial reporting. From the perspective of adopters, the increase of value relevance of accounting information after adopting new standard could be as an incentive for them, in the condition that there is no direct incentive promised to adopters.

The pros and cons around the benefit of IFRS adoption are expected to be narrowed with this results. This study supports the argumentation of proponent of the new standard that it was resulting in more transparent and comparable accounting information.

Following up the prior study that investigates the impact of IFRS adoption in multi-countries that usually too simplified the differences among countries, this study has been applied only in a single state so that the results can be specified. This study proves that IFRS is capable enough to strengthen the quality of accounting information.

This research is supported by [33] which found a positive association of IFRS adoption on accounting information quality. However, this study is the contrast to [34] that found that IFRS adoption has not been able to improve the value relevance of accounting information.

## CONCLUSION, LIMITATION AND FUTURE RESEARCH

The study is the first research that investigates the benefit of IFRS adoption using longitudinal data by comparing the value relevance of accounting information before and after IFRS adoption. The results successfully prove that the value relevance increase after IFRS adoption. This finding is expected to enhance the standard setter confidence to mandate IFRS to all firms consistently. The efforts to adopt IFRS provide excellent results, increase not only the value relevance of accounting information but also the confidence of standard setter.

This result is limited to manufacturing companies, to be more generalizable, future studies need to involve other sectors and extend the period of adoption to get more consistent results.

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