

**CORPORATE GOVERNANCE AND  
ACCOUNTING IRREGULARITIES:  
Evidence from the two-tier board structure in Indonesia**

By

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## **Abstract**

There have been, and continue to be, serious financial scandals involving accounting irregularities in leading companies. While responses to these occurrences include the introduction of tougher regulations such as the Sarbanes-Oxley Act of 2002 (SOX), further serious instances have occurred, notably the 2008 subprime mortgage and financial institution meltdown. The existence and persistence of such cases of financial scandals have led many investors, regulators, companies and academics to try to reduce such incidence by improving the effectiveness of corporate governance and increasing awareness of the red flags which could cause accounting scandals.

The relationship between individual corporate governance dimensions and corporate governance as a system orientated toward accounting irregularities has been tested. However, empirical measurements and tests are limited and largely based in one-tier board system environments. The outcomes are almost impossible to apply in two-tier board systems, where relationships between governance mechanisms and accounting irregularities are not fully understood. Using the agency theory and fraud theories, this research is undertaken in Indonesia to provide insights that extend the body of knowledge about the practices of the two-tier board system. This study investigates the extent to which the Indonesian corporate governance system acts as an effective tool in protecting financial statement users against accounting irregularities.

The study uses a matched sample of 78 Indonesian listed firms that were convicted of issuing financial statements with accounting irregularities during the period from 2000 to 2009. A cross-sectional data approach is employed to capture a sufficient number of cases with accounting irregularities. The study adopts a quantitative method with archival data. It also summarizes the characteristics of cases according to enforcement actions undertaken by governing body, before following up the analyses using ordinal logistic regression analysis.

Prior to comparison with the control group, the 78 listed firms with cases of accounting irregularities are classified according to industry, methods, perpetrators,

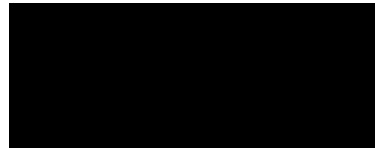
motivations and sanctions imposed. Univariate analysis with the paired firms shows that the firms with accounting irregularities have less effective supervision from their boards of commissioners (BOC) and audit committees, as well as poor integrity of management and less independent auditors, than the matched group in accordance with best practice. Specifically, the multivariate tests show that the level of seriousness in misstatements of the listed firms was more severe when: (a) there was an absence of financial expert(s) on supervisory boards and audit committees; (b) companies had short-tenured CEOs and poor internal control systems; and (c) auditors were solely appointed by firms' BOCs without the agreement of block holders. In addition, an examination of the simultaneous effects of each corporate governance dimension reveals a general weakness of BOCs and their audit committees, even though they could be effective in mitigating reporting incidences by showing high-quality collaboration.

In conclusion, this thesis makes a number of contributions and implications, specifically for Indonesian regulators concerned with the strengthening of corporate governance guidelines pertaining to ensuring the high quality of transparency and disclosures, and preventing the incidence of reporting misstatements. The evidence also adds to the knowledge-base for countries with two-tier governance structures for investigating financial scandals. The findings imply that strengthening the role of BOC (supervisory boards) and their audit committees will assist in preventing accounting irregularities. This study also supports the concept of an independent assessment of the significant deficiencies and material weaknesses of listed firms' internal control systems in order to prevent the occurrence of any future accounting irregularities in Indonesia. The limitation of the study lies in the fact that there is a potential for misclassification, when a governing body only releases some cases in detail. Thus, it contributes to the literature on corporate governance and fraudulent financial reporting, and provides significant suggestions to governing bodies in relation to the public enforcement of capital-market laws in Indonesia.

## **Student Declaration**

“I, Jaswadi JASWADI, declare that the DBA thesis entitled ‘Corporate governance and accounting irregularities: evidence from the two-tier board structure in Indonesia’ is no more than 65,000 words in length including quotations and exclusive of tables, figures, appendices, bibliography, references and footnotes. This thesis contains no material that has been submitted previously, in whole or in part, for the award of any other academic degree or diploma. Except where otherwise indicated, this thesis is my own work”.

Jaswadi JASWADI



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## **List of Publications and Awards**

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## Abbreviations

AAERs	Accounting and Auditing Enforcement Releases
ASEAN	Association of Southeast Asian Nations
ASIC	Australian Securities and Investment Commission
BAPEPAM-LK	Capital Market and Financial Institutions Supervisory Agency
BI	Central Bank of Indonesia
BOC	Board of Commissioners
BOD	Board of Directors
CFA	Chartered Financial Analyst
CFE	Certified Fraud Examiner
CIA	Certified Internal Auditor
CISA	Certified Information Systems Auditor
CPA	Certified Public Accountant
CPMA	Certified Professional Management Accountant
DSAK	Financial Accounting Standard Board
EU	Enforcement undertaken by ASIC
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GCG	Good Corporate Governance
GMS	General Meeting of Shareholders
IAI	Indonesian Institute of Accountants
IAPI	Indonesian Association of Certified Public Accountants (IICPA)
IAS	International Accounting Standards
ICFR	Internal control over financial reporting
IDX	Indonesia Stock Exchange
IFRS	International Financial Reporting Standards
LAI	Level of sanctions imposed by BAPEPAM-LK
NCG	National Committee on Governance
OJK	Indonesian Financial Services Authority
PAI	Indonesian Accounting Principles
PCAOB	Public Company Accounting Oversight Board
PERC	Political and Economic Risk Consultancy
PPNS	BAPEPAM-LK's civil investigator
PSAK	Statement of Financial Accounting Standards
ROA	Return on Assets
SPAP	Professional Standard of Public Accountants
SRA	State Registered Accountant

# **CHAPTER 1 INTRODUCTION**

## **1.1 Background to the research**

There have been, and continue to be, serious financial scandals involving accounting irregularities in leading companies in the United States of America (USA) and other countries. For example, Enron, WorldCom, HIH Insurance and One.Tel presented misleading financial statements, to name but a few. While responses to these occurrences include the introduction of tougher regulations such as the Sarbanes-Oxley Act of 2002 (SOX), further serious instances have occurred, notably the 2008 subprime mortgage and financial institution meltdown. Again, history repeats itself when news of the Madoff case for Ponzi schemes and the Satyam Indian Scandal were publicised in December 2008 and January 2009, respectively. The existence and persistence of such cases of financial scandals have led many investors, regulators, companies and academics to try to reduce such incidence by improving the effectiveness of corporate governance and increasing awareness of the red flags that indicate accounting scandals.

In finding ways to prevent accounting irregularities that lead to economic problems, many scholars have tried to develop a model to explain the corporate governance mechanism and its role in detecting and preventing accounting irregularities (Abbott, Park & Parker 2000; Archambeault 2000; Beasley 1996; Bourke 2007; Bourne 2008; Chen et al. 2006; Sanbeh 2010; Smaili & Labelle 2009). New ideas include: increasing the role and number of independent directors; eliminating the chairman-CEO duality; and refining the measurement of accounting irregularities. However, little is known about this area outside the US and other developed countries, due to the lack of availability of data like the information published by US Securities and Exchange Commission (SEC) and the stock exchanges. Although several studies have been conducted in developing countries with emerging economies, such as Indonesia, these are limited (see Hasnan, Rahman & Mahenthrian 2009; Mayangsari & Sudibyo 2005).

Much of the literature shows that the incidences of accounting irregularities are often associated with poor corporate governance. However, corporate governance studies have been largely undertaken in the one-tier board system environment, meaning that the outcome of the research is almost impossible to apply in other circumstances, such as in the two-tier board system. The relationship between the corporate governance systems and accounting irregularities in the two-tier board environment may not be properly understood.

Previous research on accounting irregularities has concentrated only on one type of irregularity at a time, and has classified the incidence of irregularities but not the gravity of these irregularities (see, for example, Abbott, Park & Parker 2000; Beasley 1996). It is crucial to identify and consider the gravity of incidence of accounting irregularities, instead of classifying them as similar incidences (for example: as in a case of comparison research differentiating non-compliance firms from compliance firms). In other words, it must be taken into account that accounting irregularities appear across an error-fraud continuum (AICPA 2002; APB 1995; Kwok 2005; Smaili & Labelle 2009). At one end of the spectrum, accounting irregularities are misstatements caused by unintentional mistakes or errors. At the other end of the spectrum, accounting irregularities are known as fraud, involving those charged with governance.

In order to gain more insight into accounting practices in the two-tier board system, this research uses an Indonesian institutional setting that represents this specific environment. Within a two-tier board system, there is a supervisory board (or board of commissioners or BOC) that is the owners' representative, elected by shareholders, and it has the duty to appoint and oversee the board of directors (BOD). The BOD leads the company and makes strategic and operational decisions, which are executed by managers (Djonieri 2010). Thus, the BOC – not the BOD – has the right to obtain any information relating to the firm, to ask for an audience with directors and to call a shareholders' meeting if necessary. Even though previous research in corporate governance has been done in a similar institutional setting in Germany, Austria, Denmark and the Netherlands (Davies 2006), there is limited literature that explains the relationship between the corporate governance systems and accounting irregularities.

In addition, this research follows the line of enquiry of Smaili and Labelle (2009) who used regulatory data to indicate which governance mechanisms determine the seriousness of accounting irregularities. When this type of incidence is detected by regulators, this indicates that the firm's governance system failed to prevent the financial misstatement, whereas if it is detected by an internal auditor, audit committee or external auditor, this usually constitutes effective governance. This study replicates Smaili and Labelle (2009) research in some ways and applied to the Indonesian context. In Indonesia, the Indonesian Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK) is charged with enforcing all aspects of the securities laws in Indonesia and its powers and operations are similar to those of the SEC in the United States. BAPEPAM-LK investigates allegations about securities fraud and makes enforcement actions in cases of fraud and malpractice.

## **1.2 Research problem**

The present study argues that attributes of the corporate governance systems influence the seriousness of accounting irregularities. Research has been conducted in developed Western countries and in one-tier board structures. However, no previous studies have been identified which focus on the influence of the corporate governance systems on the incidence of accounting irregularities in a two-tier board system. Many civil law countries (LaPorta et al. 2000; Sama & Shoaf 2005) and Indonesia have adopted a principle-based approach concerning governance best practice. This current study is conducted in Indonesia as the 'comply or explain' approach representing this institutional setting allows more opportunity to the choice of governance strategy. The research question that arises from this issue is:

*What is the effect of individual corporate governance attributes, and the governance systems, on the gravity of incidence of accounting irregularities in Indonesia?*

## **1.3 Objectives of the study**

The four primary objectives of the study are to:

1. identify and fill particular gaps in the literature in conceptual and contextual terms;



2. develop an enhanced empirical model;
3. provide evidence that will test several new and modified hypotheses or inform previously established hypotheses;
4. present implications of the study's finding for wider corporate governance issues in the relevant organisations; and
5. make country and context specific recommendations.

## **1.4 Contributions to knowledge**

This study leads to potential contributions to knowledge in several ways:

1. It fills the knowledge gap in the literature with a detailed analysis of the relationship between corporate governance systems in two-tier board systems and the gravity of accounting irregularities in the setting of developing countries.
2. It fills the existing gap associated with the effectiveness of monitoring by the supervisory board over the board of directors behaviours and board committee effectiveness, and also extends knowledge by providing empirical evidence regarding the effect of corporate governance as a system on accounting misstatement scandals, in addition to the effect of individual governance attributes (Abbott, Park & Parker 2000; Beasley 1996; Uzun, Szewczyk & Varma 2004).
3. It is one of the few studies that uses regulatory law enforcement data in academic research aimed at linking poor governance and financial misstatement practices (Chen et al. 2006; Smaili & Labelle 2009).

## **1.5 Statement of significance**

In order to minimise accounting irregularities, vigilant and effective corporate governance can substantially decrease the instances of both management and employee fraudulent behaviour and significantly detect and prevent occurrences of accounting irregularities (Rezaee & Riley 2010). Financial misstatement practices persist, even post-SOX Act (e.g. Centurygate 2008 in Indonesia, costing US\$600 million in government bailout); therefore:

1. This study provides some input for the deliberations of policymakers and regulators so they can review the effectiveness of current governance mechanisms and other related regulations and consider lifting the standards.
2. This study highlights the red flags of accounting irregularities that are considered early-warning signals, to protect current and prospective investors, creditors and other main users of financial statements.
3. This study also provides empirical evidence for those involved in corporate governance systems, including: board of commissioners and their committees; board of directors; auditors and other statutory bodies, to enhance their accountability by improving their corporate governance effectiveness in the two-tier board system environment.

## **1.6 Scope of the research**

The scope of the current thesis focuses on listed firms with accounting irregularities at various levels of severity on the Indonesian Stock Exchange (IDX), ranging from 2000 to 2009. The population of this study comprises all sectors of the Indonesian economy, except for state-owned enterprises and private companies.

The present research focuses on the area of the effect of corporate governance on the deterrence of accounting irregularities, along with the investigation of: board of commissioners effectiveness; audit committee effectiveness; board of directors (as top management team) effectiveness; audit quality; and interaction effects among the governance mechanisms.

## **1.7 Definition of key terms**

**Corporate governance** is “the system by which companies are directed and controlled” (Cadbury 1999, paragraph 2.5). In this study corporate governance is defined as a system of regulating and overseeing corporate conduct and of balancing the interests of all internal and external stakeholders who can be affected by the company’s conduct, in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for corporations (DuPlessis, James & Mirko 2005,

p.10). A system of corporate governance is made up of mechanisms/attributes such as structure and processes, policies/laws and people.

**Board structure** is generally divided into two types, the unitary board and the two-tier board (DuPlessis, James & Mirko 2005). “Unitary board of directors further characterizes the Anglo-Saxon countries: executive and supervisory responsibilities of the board are condensed in one legal entity” (Weimer & Pape 1999, p.154). Boards of directors consist of executive (inside) and non-executive (outside) board members. From the practical point of view, outside board members advise the inside directors regarding major policy decisions in the best interest of shareholders. Both inside and outside directors are appointed and dismissed by general meeting of shareholders.

In this study, a two-tier board system separates a management board (also known as board of directors according to Indonesian legislation) and a supervisory board (board of commissioners), which provides a complete separation between the top management team and supervision of the management (Lukviarman 2004). From the legal point of view, the board of commissioners has the duty to monitor the competence of the board of directors and to advice on the major policy decisions. On behalf of a general meeting of shareholder, a board of directors might be dismissed by a board of commissioners (Kamal 2008).

**Accounting irregularities** are misstatements in financial statements and can arise from either error or fraud (Kwok 2005, p.21). **Accounting error** refers to an un-intentional misstatement in financial statements, including the omission of an amount or a disclosure, whereas **accounting fraud** comprises both the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentation affecting the financial statement by one or more individuals among management, employees or third parties.

## **1.8 The organisation of the thesis**

This present thesis is structured to provide empirical evidence and recommendations with regard to the Indonesian corporate governance context and the incidences of

financial misreporting of listed firms at the Jakarta-based Indonesian Stock Exchange (IDX). This thesis consists of seven chapters as follows.

**Chapter 1** provides a brief introduction to the background of the study, along with the research problem. It also outlines the research objectives, the contribution to the knowledge and practical significance, scope, key terms and structure of the thesis.

**Chapter 2** reviews the literature regarding the agency theory, corporate governance development and accounting irregularities along with discussion of their motives, underlying theories, detecting tools and seriousness. A summary of previous research that has uncovered the relationship between corporate governance systems and prevention of accounting irregularities is also highlighted.

**Chapter 3** presents a review of the Indonesian economy, current corporate governance implementation and its accounting systems. An overview of the development of the country's economy and stock market is highlighted. It is followed with a review of the legal foundation of the corporate governance adoption with the two-tier board structure. The 2006 Code of Good Corporate Governance is fully voluntary and it is not incorporated into a specific regulation (World Bank 2010). Therefore, this chapter also reviews the implementation of corporate governance, since regulators use the Code as a reference for developing their specific corporate governance. The financial reporting system in Indonesia is examined to see how it fulfils the transparency and disclosure principles of good governance. It is followed by a review of potential problems of accounting irregularities.

**Chapter 4** presents the research framework used to guide the study. This consists of research questions that arise from this study, a conceptual framework and the hypothesis development.

**Chapter 5** explains the research design adopted in this study. A justification of the quantitative approach is provided, with a description of the method of collecting the data and a summary of sample description. Discussions of the operationalisation of the

variables that are used in this research, along with the justification of each variable, are also presented. Furthermore, the method used to analyse the data, including univariate and multivariate approaches, is described.

**Chapter 6** presents the analysis of the results of the current research. It gives a descriptive analysis of the current study. It comprises the analysis of the demographic characteristic of the samples, the present preliminary data analysis relating to differences between research samples and matching group samples. It includes all the steps determined to analyse the data. The inferential statistical analysis and discussion of corporate governance features contributing to the likelihood of accounting irregularities are then discussed.

**Chapter 7** includes the concluding remarks of this current study, along with the implications derived from the results, the limitations of the study and suggested future research.

## **CHAPTER 2 LITERATURE REVIEW ON CORPORATE GOVERNANCE MECHANISMS AND NATURE OF ACCOUNTING IRREGULARITIES**

*An ounce of prevention is worth a pound of cure.  
In few other business contexts is that as true as  
with financial statement fraud. (Young & Nusbaum 2006, p.211)*

### **2.1 Introduction**

This chapter provides a review of the literature in order to understand the role of corporate governance in preventing and detecting the occurrence of error and fraud. To begin with, there is a discussion of the development of corporate governance in the one-tier board system. The next part details the nature and underlying theories of accounting irregularities. The final section of the chapter describes the main criticism of corporate governance mechanisms, with particular emphasis on their use in the prevention of serious misleading financial reporting. The theoretical background for the research topic that is explored in this chapter is complemented by Chapter 3 which highlights the historical and regulatory development of the corporate governance and accounting system in Indonesia.

### **2.2 Agency theory**

Separation between ownership and control is a common characteristic of the modern corporation (Berle & Means 1932). Moreover, these authors argue that there are three functions within an enterprise, namely: that of having interests in an enterprise; that of having power over an enterprise; and that of acting with respect to an enterprise. Before the industrial revolution, as do most farmers today, the owner-worker performed all three functions. Then, under the mass-production system, the owner perhaps fulfilled the first two functions or delegated management and received the shared profit that might accrue. Nowadays, under the corporate system, the second function mostly has become separated from the first. The position of owner has been reduced, and the

management is in the position of having legal and effective power over the enterprise. Berle and Means's concern is developed as "a theory of the firm" by Jensen and Meckling (1976), known as agency theory. This theory refers to the principal-agent problem, where the principal faces the problem of motivating the agent to act on their behalf. In order to reduce this problem, Jensen and Meckling (1976, p.308) define an agency relationship as:

a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximisers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint.

In this regard, this theory is developed with the assumption that the agent is individualistic and has self-serving behaviours. Thus, to limit the variance of achieving goal congruence, principals use several means to monitor agents. These include efforts such as budget restrictions, operating rules and compensation policies. The agency theory points out the separation between shareholders and management and how some contract is necessary to minimise the agency costs, including *monitoring costs*, *bonding costs* and *residual losses*, that may arise from the relationship problem.

Agency theory is concerned to solve the contracting problems that may occur in a particular agency relationship (Eisenhardt 1989). The first type is the agency problem that arises when: (a) the expectations of the principal and agent conflict which is moral hazard; and (b) it is not easy and is expensive for the principal to verify what the agent is really doing, known as adverse selection conditions. The second problem is risk sharing. The principal and agent may take different actions due to their different risk preferences. The overall domain of agency theory is relationships that use the basic

agency structure of a principal and an agent who are engaged in cooperative behaviour. Table 2.1 provides a summary of agency theory.

**Table 2.1. Agency theory overview**

<i>Key idea</i>	Principal–agent relationship should reflect efficient organisation of information and risk-bearing costs
<i>Unit of analysis</i>	Contract between principal and agent
<i>Human assumption</i>	Self-interest Bounded rationality Risk aversion
<i>Organisational assumption</i>	Partial goal conflict among participants Efficiency as the effectiveness criterion Information asymmetry between principal and agent
<i>Information assumption</i>	Information as a purchasable commodity
<i>Contracting problems</i>	Agency (moral hazard and adverse selection) Risk sharing
<i>Problem domain</i>	Relationship in which the principal and agent have partly differing goals and risk preferences (e.g. compensation, regulation, leadership, impression management, whistle-blowing, vertical integration, transfer pricing)

Source: (Eisenhardt 1989, p.59)

Shleifer and Vishny (1988) provide an illustration of how principal–agent conflicts could become a serious moral hazard. As a human being, the company manager has many individual ambitions and goals one of which is to become wealthy. Accordingly, they will run the company to some extent reflecting their individual goals. On the other hand, shareholders may only care about getting capital gains and dividends from their own stock. For this reason, when managers fail to keep a positive financial performance, conflicts will clearly arise.

In another study, Denis (2001) reports that there are three kinds of such conflict: (1) managers' desire to remain in power and, on the other hand, shareholders' wish to replace them if they have not performed well; (2) different views towards risk aversion of the investment policy, in that a typical shareholder holds a well-diversified financial portfolio, whereas a manager has the majority of their human capital tied up in a particular firm; and (3) different views about how to use the firm's free cash flow, the manager usually preferring to hold onto the cash flow and/or invest it even in negative



net present value (NPV) projects rather than return it to shareholders. Managers may wish to maximise the assets under their control to increase the compensation basis, such as total company assets.

An agency problem is not unresolvable. Some studies have proposed general solutions to minimise agency costs by encouraging management to act in the best interests of shareholders with “bonding solutions”, “monitoring solutions” and “incentive alignment solutions” (Denis 2001; Dharwadkar, George & Brandes 2000). As an example of a bonding solution, a corporate manager may be asked to sign a contract specifying that they always takes an action to maximise shareholders’ value. Monitoring solutions need effective devices that allow for credible monitoring over the management. There are a number of potential monitoring tools for a firm’s top management, such as corporate governance mechanisms. The last solution – incentive alignment – seeks to reduce the degree of agency conflict by using incentives. If a stockholder expects a return in the form of capital gains and dividends, then management also thinks the same way, to get a benefit from increasing the value of a firm. These first two solutions – bonding and monitoring – are regarded as ‘sticks’ and incentive matters can be seen as ‘carrots’ for minimising agency costs.

Mechanisms are put in place to mitigate the agency problems and accounting is one such mechanisms. Accounting has been used to facilitate efficient contracting (Watts & Zimmerman 1986, 1990). Accounting also has a role in measuring the firm’s performance and wealth. As accounting numbers are used to determine manager compensation (see, for example, Barkema & Gomez-Mejia 1998), managers have a tendency to manage a firm’s earnings due to its impact to their wealth. Earnings management is also aimed at avoiding the breaching of a creditor’s debt covenants, and reducing political costs (Watts & Zimmerman 1990). For this reason, shareholders put monitoring mechanisms in place, such as corporate governance systems (Lubatkin et al. 2005) (see section 2.3), to ensure the reliability of firm’s financial reporting.

Furthermore, there has been another form of agency conflict, as well as conventional agency conflict between principal and agent. La Porta et al. (1998) provide evidence

that weak investor protection is more likely when public corporations have heavily concentrated ownership. The authors contend that concentrated ownership could trigger a cost. One of these is the likelihood of difficulties in raising equity finance, since minority investors fear expropriation by a company's managers and a firm's controlling shareholders. The expropriation may take a variety of forms, such as asset tunnelling (Johnson et al. 2000; Machfoedz et al. 2009), transfer pricing and excessive managers compensation. There has been a change in the agency problem from a simple manager–shareholders conflict to a conflict between minority shareholders and controlling shareholders (Lukviarman 2004).

It is argued that effective solutions for agency problems need adequate disclosure to minimise the information asymmetry that exists between the principal and agent (Achmad 2007). Therefore, this can reduce agency costs. Unfortunately, the solutions may only work in a strong governance context, mostly in developed economies, and may not performed well in an opposite weak-governance context, mostly in emerging economies (Dharwadkar, George & Brandes 2000).

## **2.3 Corporate governance**

As noted in section 1.7, **corporate governance** is defined as “the system by which companies are directed and controlled” (Cadbury 1999, paragraph 2.5). In this study, corporate governance refers to the systems which regulate and oversee corporate conduct and balance the interests of all stakeholders with regard to ensuring responsible corporation behaviour and achieve companies' efficiency and profitability (DuPlessis, James & Mirko 2005).

The importance of good corporate governance is highlighted by the collapse of such important corporations as Barings Bank in 1995, Enron in 2001 and Royal Ahold in 2003 (2004). These three examples highlight high-profile companies in the UK, US and Europe and illustrate shortcomings in the way these companies were managed. The case of Barings Bank highlights the lack of effective internal control and the extreme trust of one staff member without supervision or understanding of his investment policy. The Enron situation emphasises a clear need for directors' integrity and honesty, and the key

role of an independent external auditor in engaging audit tasks. Royal Ahold illustrates what happens if investor monitoring mechanisms are concealed, where the CEO was the only dominant actor within the corporate structure.

Such incidences exemplify the need to tighten the existing corporate governance principles and regulations. In doing so, corporate governance studies should continue to sharpen their investigation focus, for example transparency and disclosure, control and accountability, and the most suitable structure of board systems that may be more capable of deterring such scandals from occurring in the future (Mallin 2004). The following section discusses the development of corporate governance and its mechanisms.

### **2.3.1 Corporate governance: international development**

The implementation of good corporate governance is becoming increasingly important in the daily business world (Mallin 2004). The corporate governance systems are used as one of the corporation tools, including mitigating agency problems between the principal and agent according to agency theory. Moreover, other theories are used to interrogate corporate governance across disciplines including law, organisational behaviour, management, accounting, finance and economics (Mallin 2004).

The stage of corporate governance development refers to the evolution of corporate structures, ownership groups, the economy and other aspects, all of which affect how these are accommodated within their own national setting. Among other things, an important feature of the development is whether the business entity operates within shareholders or stakeholders approaches (see, for example, Enriques & Volpin 2007; LaPorta, Lopez-de-Silanes & Shleifer 1999; Wibowo 2008).

A corporate governance “deals with ways in which suppliers of finance to corporations assure themselves of getting a return on their investments” (Shleifer & Vishny 1997, p.737), problems emerge when the suppliers of finance, which is the owners, hire other people (the top management team) to responsibly run the business on a daily basis. The problems are likely to occur when the interests of those parties are diverse and the

information for decision-making becomes asymmetric (Berle & Means 1932; Jensen & Meckling 1976). In regard to minimising asymmetrical information from both parties, many pieces of literature suggest the importance of a board of directors to create a connection between owners and managers. Each of shareholders or stakeholders approaches has different attributes of corporate governance systems.

Previous studies have reported that there are two general corporate governance models in the international context – the continental European and the Anglo-American (DuPlessis, James & Mirko 2005; Enriques & Volpin 2007; Wibowo 2008). The German model represents the continental European type, using the stakeholders approach, whereas the US counterpart represents the Anglo-American one, using the shareholders approach.

In general terms, Kaplan (1997) identifies that the US corporate governance approach is characterised as a market-based system in which company ownership is diffused among capital market investors; thus market control is relatively very strong, with boards of directors mostly nominated from independent directors. Conversely, Kaplan also highlights that the German approach is situated within an illiquid capital market, corporation ownership is concentrated in several groups, and board members are dominated by conglomerates, inter-corporately related, and banks. In relation to ownership, an ownership index has been suggested by LaPorta, Lopez-de-Silanes and Shleifer (1999), who confirm that the ownership structure among listed firms in the US is unconcentrated, while in Germany it tends to be more concentrated.

Germany is implementing the two-tier board system, whereas the US adopts the unitary or one-tier board system (Firth, Fung & Rui 2007; Hopt 1998). German corporations typically use both a supervisory board (*Aufsichtsrat*) and a management board (*Vorstand*). The supervisory board has the roles of monitoring management in order to protect shareholders and maintaining relationships with labour. Inside the supervisory board, there are not only independent commissioners, but also bank and union representatives (Davies 2006). Other countries have adopted the same system, such as

Austria, Denmark, the Netherlands, and China. Indonesia, as an emerging economy, has also been applying this system since its link with the Dutch during the colonial era.

In their development, two-tier board systems promise the benefit of full separation between non-executive directors and executive directors. However, some doubt the effectiveness of a monitoring role by a supervisory board which consists of non-executive directors only, due to the inadequate information flow from the management board to the supervisory board, as well as from the chairman of the supervisory board to other board members (Hopt 1998). There are also issues relating to their effectiveness, since the German system, for instance, employs large numbers of members on the supervisory board with infrequent meetings and underdeveloped committees (Elston & Goldberg 2003; Enriques & Volpin 2007; Hopt 1998).

The other board system is the one-tier board system, which fits with the ideal of so-called “shareholders’ supremacy” (Farrar 2008). This system has typically been adopted by US companies. Using this structure, executive and non-executive directors convene to form one board together. Executives perform a double function: as directors they are concerned in board matters, and as executives they account for the operations and the daily execution of board decisions. Therefore, within this system, the degree of the board of directors’ role in protecting shareholders’ interest, to some extent, depends on their attributes, including the composition of unrelated members and board size in general (Beasley 1996).

However, there is no ‘one size to fit all’ in relation to practice including board structures. In order to incorporate specific values, a particular country needs to create its own standard. Some scholars strongly oppose the issue of a global standard being immediately implemented. Iu and Batten (2001) propose a balanced view, that even the conduct of commerce between nations on completely similar terms and conditions does not translate into homogeneous culture constructs. Cultural differences also remain. The Asian Development Bank (ADB 1999, 2000) and the World Bank (1999) assert that there is no single model of corporate governance that can be applied to solve corporation problems in every different circumstance. In a specific statement, ADB

(2000a, p.6) argues that “(e)ach country should formulate its own reform plan and implement measures that suit its specific condition”.

### **2.3.2 Development of corporate governance codes**

During the development of corporate governance, each stage has seen the introduction, or amendment, of a corporate governance guideline in a number of countries. Legal background (civil law in France vs. common law in the US), political and cultural context (communist in China vs. democracy in Australia), business structure (listed company compared to family-owned business) and ownership (institutional investors in the US vs. block holders in Germany and state ownership in Communist countries) provide the contexts of these. Despite these differences, the introduction of new corporate governance has generally been encouraged by a motivation for more accountability and transparency and increasing both current and potential investors' confidence (Mallin 2004, p.19). The announcement of new codes is eventually driven by severe financial scandals, economic crisis and other corporate jeopardy. The following sections describe, briefly, Code development in the UK, OECD and US.

#### **2.3.2.1 The UK Combined Code**

The first ever UK Combined Code was announced in 1998 and drew together the recommendations of the Cadbury Report (1992), Greenbury Report (1995) and Hampel Report (1998). Firstly, the Cadbury Report was published in December 1992 in response to the various financial scandals and collapses (BCCI and the Robert Maxwell affair, to name a few) in the late 1980s and early 1990s. Since its publication, the London Stock Exchange has required the inclusion of a statement of corporate governance in listed firms' annual report and accounts. Secondly, during the 1990s, the issue of the director's incentive was becoming a main concern for investors at large. The Greenbury Report (1995) addressed the recommendation to link a director's remuneration to a company's performance. Thirdly, the Hampel Report (1998) emphasised principles of good governance rather than explicit rules in order to reduce the regulatory load on companies and avoid the behaviour of “box ticking”. It was considered that, to some extent, good corporate governance basically depends on the

specific situation of each company. The Hampel Report's emphasis on the principle of "comply or explain" has survived into the Combined Code 1998.

The Combined Code is widely regarded as an international benchmark for good corporate governance practice. It has been revised several times and the latest version was released in 2010. In complete contrast to the mandatory systems in the USA, the UK Code emphasises flexibility in companies' choosing between complying with its recommendations and explaining why they did not. "The merits of such flexibility – known as the comply or explain model – are thought to encourage companies to adopt the spirit of the Code; whereas a more mandatory regime would lead to a 'box ticking' approach that would fail to allow for sound deviations from the rule and end up not fostering investors' trust" (Arcot, Bruno & Grimaud 2005, p.1).

#### **2.3.2.2 OECD Principles of Corporate Governance**

The Organisation for Economic Co-operation and Development (OECD) currently consists of 31 countries and has a significant role in promoting development ideas among its members. Most OECD members are regarded as developed countries with high incomes and a high Human Development Index. This forum's importance and influence is strengthened by accession by: 4 candidate countries (Estonia, Israel, the Russian Federation and Slovenia); 5 countries seeking enhanced engagement (Brazil, China, India, Indonesia and South Africa) and more than 25 non-member countries that regularly participate in OECD schemes or programs. The forum facilitates the enhancement of democracy and the market economy, provides guidance for comparing policy experiences, indicates good practices, resolves to common obstacles, and coordinating both domestic and international policies of its members (OECD 2011).

In relation to developing a Code for Corporate Governance, in April 1998 the OECD Council initiated the development of a set of corporate governance standards and guidelines. The OECD, therefore, established the Ad-Hoc Task Force on Corporate Governance to specify a set of non-binding principles that represent the opinions of member countries on this issue. The principles are aimed to assist the 31 member countries and non-member governments to develop and improve the regulatory

framework for implementing corporate governance in each country. In 1999, the OECD officially announced its first ever principles, which consist of five principles (see Table 2.2).

The 1999 OECD principles are designed so that publicly traded companies can improve the level of corporate governance (Mallin 2004) and have been widely adopted by member and non-member countries. Moreover, as in the Cadbury Report, their usage is also strongly recommended for other forms of business such as private companies and state-owned enterprises (SOEs). For example in 1999, Greece as a country member substantially drew on the OECD principles in developing its country's code and in 2001 China did the same thing.

**Table 2.2 OECD Principles of Corporate Governance**

Principle	Description
<i>The right of shareholders</i>	The corporate governance framework shall protect stockholders' rights.
<i>The equitable treatment of shareholders</i>	The above framework also should ensure the balanced treatment of all shareholders, including minority interest and foreign investors.
<i>The role of stakeholders in corporate governance</i>	The frameworks also should recognise the rights of stakeholders as mandated by law and encourage mutual assistance between stockholders and management in creating wealth, employment and financially sustainable corporations.
<i>Disclosure and transparency</i>	The framework should maintain a timely and reliable disclosure on all material things related to corporations, such as financial matters, company performance, change of ownership, and the governance of the company.
<i>The responsibilities of the board</i>	The corporation strategic guidance, the effective monitoring board over management and board's accountability to company and shareholders shall be addressed in the corporate governance framework.

Source: OECD Principles of Corporate Governance (1999)

Among other things, the OECD principles are intended to be concise, understandable and accessible to the international community. They are not projected to replace private



sector initiatives to develop more detailed “best practice” in corporate governance (Mallin 2004).

In 2003, the OECD initiated a review of the 1999 principles to take into consideration recent developments, such as corporate scandals, through a process of open and extensive consultations. The revised Principles were approved in April 2004 by OECD governments (Jesover & Kirkpatrick 2005; OECD 2004). They reflect not only the experience of OECD members, but also incorporate that of developing economies involved in the Regional Corporate Governance Roundtables held by the OECD and the World Bank Group. In addition to the 1999 five principles, a principle of ensuring the basis for an effective corporate governance framework has been highlighted. This additional principle, compared to the 1999 Code, is highly relevant since a weak institutional framework for corporate governance is incompatible with sustainable financial market development and growth (Claessens 2003).

#### **2.3.2.3 US corporate governance**

US corporate governance practice is not derived from one code, but is shaped by a number of codes that have come out of federal and state developments over a number of years. Among other things, this subsection discusses the exceptional contribution to US corporate governance of: the Blue Ribbon Committee 1999; Sarbanes-Oxley Act 2002; Commission on Public Trust and Private Enterprise 2003; NYSE Corporate Governance Rules 2003; and National Association of Corporate Directors’ (NACD) Key Agreed Principles of US Publicly Traded Companies 2008. Each of these is dealt with in more detail in the following paragraphs.

In 1998, the NYSE and National Association of Securities Dealers (NASD) formed the Blue Ribbon Committee (BRC) to develop recommendations aimed at improving financial reporting by enhancing or strengthening an audit committee’s role as a financial monitor (Abbott, Parker & Peter 2004). One year later, in 1999, the BRC published a number of recommendations on improving the effectiveness of corporate audit committees. The BRC’s recommendations addressed some audit committee features such as: member independency; committee size; and member financial

expertise. The Securities and Exchange Commission (SEC) adopted the BRC recommendations concerning the features of audit committees, and these became effective after 15 December 2000. Abbott, Parker and Peter's findings underscore the importance of the BRC's recommendations as a means of strengthening the monitoring and oversight role that the audit committee plays in financial reporting processes, and this supports the previous results of McMullen (1996) and Beasley (1996).

Following financial scandals such as Enron, WorldCom and Global Crossing in which it was perceived that a close relationship between companies and their external auditor was fundamentally to blame, the US Congress decided to reform the stock exchange listing rules. The changes came into effect in the Accounting Industry Reform Act 2002. Since it was co-sponsored by Senator Paul Sarbanes and Republican Michael G. Oxley, it is widely known as the Sarbanes–Oxley (SOX) Act 2002 (Arping & Sautner 2010). The SOX Act 2002 has had a significant impact in preventing such scandals, not only in the US but around the world (Mallin 2004).

Another important US corporate governance milestone is the development of NYSE listing standards made as a response to the request from SEC Chairman Harvey Pitt to review its corporate governance listing standards. The committee reviewed the standard “with the goal of enhancing the accountability, integrity and transparency of the Exchange’s listed companies”(CALS 2002, p.1).

The final NYSE (2002) Corporate Governance Rules (Section 303A of the NYSE’s Listing Company Manual) require that a listed company must have: a majority of independent directors and sets down rules for the terms of independent directors; effectiveness of non-executive directors meeting without management; a nominating and compensation committee consisting of independent directors only; composition and audit committee size; a code of conduct; and disclosure of corporate governance implementation. This rule has been amended several times, including November 2009 when the SEC approved certain disclosures via posting on a company website and without having to provide them in print form. These changes have been in effect since 1 January 2010 (SEC 2009).

### **2.3.3 Internal and External Corporate governance**

Banks (2003) distinguishes the definitions of internal and external corporate governance. Internal governance is based on specific mechanisms and action taken by individual firm to enforce control and accountability, whereas external governance is about how bodies external to a company establish and enforce frameworks which an organisation own corporate governance systems should operate.

The nature of corporate governance is affected by factors including internal mechanisms/attributes within corporate boundaries as well as external environment elements (Standard & Poors 2002). Internal governance structure and processes are applicable only within an individual company. Ownership structure and influence, financial stakeholders' rights and relations, financial transparency and information disclosure, and board structure and process are among the internal mechanisms, whereas the external factors that play a role are a country's legal structure, regulations, information infrastructure and also market infrastructure. The degree of governance in particular companies depends on the internal and external environments.

#### **2.3.3.1 Internal corporate governance**

Banks (2003) and Yoshimori (2005) are among the scholars who early emphasised the importance of internal corporate governance. This term is defined as the duties performed by a company's governance structure, including the board of directors, top management team, and independent control functions. Corporate governance lacks effectiveness where it acts as "box ticking" to comply with the regulations (OECD 2004). Yoshimori (2005) argues that scholars have been preoccupied with the external governance system and suggests looking more closely at internal governance mechanisms. The notion of internal governance does not dismiss the importance of external governance, but stresses more reliance on internal compliance with governance mechanisms. Banks (2003) argues that within any national system (i.e., the external governance dimension), there are standards to be followed by the board of directors and executive management in running companies (i.e. the internal governance dimension). If these external and internal rules are sustained, the principals' interest will be securely maintained.

Standard and Poors (2002) determine four individual components that contribute the overall company (or internal) corporate governance scores. Each individual component is explained below.

Firstly, understanding **the ownership structure of the corporation** is crucial, particularly when there is a known majority shareholder who may exist on the basis of collusive shareholding engagements. The issue of transparencies of ownership should be adequately disclosed to assess the extent to which block holders act in the interest of all shareholders. Similarly, an understanding of whether the company engages in affiliation arrangements among shareholders should not be a drawback for investing community and minority shareholders.

Secondly, **financial stakeholder relations** reflect a corporation's treatment of its financial stakeholders. The company shall provide clear shareholders' meeting procedures to exercise their voting right, including the regularity of information to make informed voting decisions. Financial right is the other aspect of securing the shareholders' interest. There should be secure methods of ownership of shares and full transferability of shares.

Thirdly, **transparency** involves a timely disclosure of information concerning a company's corporate governance practices, its operation and financial performance (McGee & Yuan 2009). In a well-governed company, timely reporting is a must since it enables stakeholders to effectively monitor management actions. Standard and Poors (2002, p.9) mention that "in certain countries where accounting standards are limited, a commitment of transparency means that the company adopts international standards in addition to that local accounting".

The last feature of internal corporate governance is **the board structure and processes**. This feature addresses the role of board of directors to independently oversee management performance and encourage management accountability to shareholders and other stakeholders. High accountability board is eventually including strong base of

outside or independent directors that ensure no expropriation of all shareholders' interest – both majority and minority shareholders (Standard & Poors 2002).

With regard to the notion of internal corporate governance, many studies focus on issues related to its compliance with corporate governance regulation and other law enforcements, to some extent they neglect the level of duty fulfilled by each party within governance mechanisms. There are just a few studies which provide a clear explanation of the degree of fulfilment of the duties of the BOD, executive management, audit committee and other internal corporate mechanisms (Wibowo 2008; Yoshimori 2005).

### **2.3.3.2 External corporate governance**

Standard and Poors (2002) consider that different approaches of corporate governance may exist, reflecting the nature of local legal and regulatory frameworks. There are four key factors, which are discussed below.

Firstly, an **effective legal environment** is fundamental to good corporate governance. In this circumstance, stakeholders' legal right shall be clearly enforced. The general rule of law is important to protect the abuse of stakeholders' rights. Among various regulations, company law, securities law and bankruptcy law shall be effectively implemented in order to regulate good corporate governance.

Secondly, the **role of regulatory bodies** is being charged with ensuring that the market conforms to existing laws. Regulatory bodies could exist as a central bank, individual government ministries or a financial service authority. Moreover, a self-regulatory organisation (SRO) is established to complement the regulatory process.

Thirdly, **informational infrastructure** is the other external issue for improving the effectiveness of corporate governance mechanisms. There are different accounting principles from country to country, with these differences usually reflecting varying business practices, such as taxation and the degree of disclosure. Disclosure regulation produces an accurate, complete and timely manner of company information. Poor

standards of information infrastructure increase the possibilities for corporate governance abuses.

Lastly, other **country-specific aspects** are how the market is functioning to facilitate the practice of corporate governance. There are different approaches to how the public capital market versus the private capital market understands the financing mechanism in corporate sectors. The US and the UK are good examples of how shareholders are diverse within a single public company. In other countries, significant ownership or cross-ownership by banks and industrial enterprises may have a dominant role to play in the functioning of the market.

External corporate governance is influenced by the “hardware” of corporate governance systems – rules, institutions and technical framework (Tabalujan 2002). The influences on corporate governance “hardware” generally appear to be recognised as two different models of governance mechanisms in developed countries. The first model is a relationship-based model, which emphasises the maximization of stakeholders’ value, while the second model is a market-model, which focuses on a maximisation of stockholders’ value.

Moreover, the functioning of the civil and criminal justice system is an important aspect underlying the implementation of both the stakeholders and the shareholders model (Tabalujan 2002). It is doubtful whether corporate governance systems can be effectively implemented in transitional and developing countries, since many lack justice systems that work in a credible and proper manner. Such countries may fail to enforce effective corporate governance. Strong supportive country governance mechanisms could be positively associated with the effectiveness of internal corporate governance (Claessens 2003; Tabalujan 2002). Country governance classification is about the degree of protection that investors and other financial stakeholders would receive should a previously highly scored company’s corporate governance standards deteriorate (Standard & Poors 2002).

## **2.4 Accounting irregularities**

It is the responsibilities of those charged with the above governance discussions to ensure, by overseeing management in establishing a control environment as far as possible, the integrity of financial reporting systems. This section discusses the concept of accounting irregularities and reviews the empirical conditions behind their incidences and the measurement of their severity.

### **2.4.1 Definition of accounting irregularities**

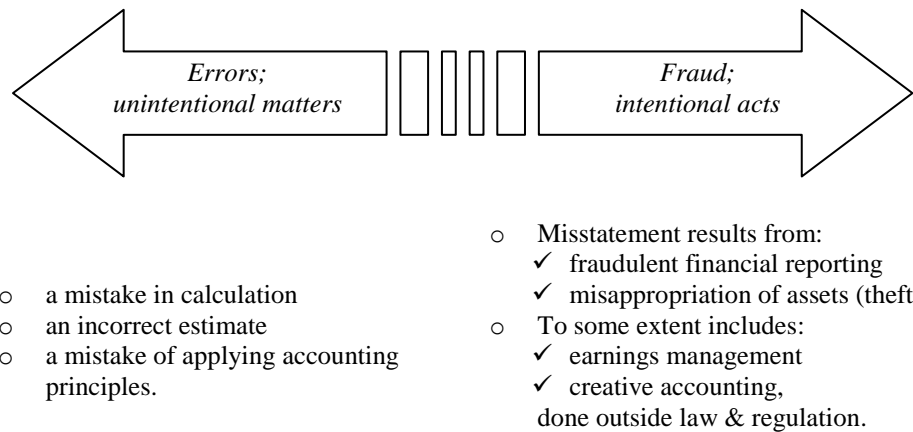
Accounting irregularities are not formally defined in the general accepted accounting principles (GAAP). Professional literature defines accounting irregularities as any accounting practices that are in violation of GAAP (Kwok 2005). These accounting issues are mostly related to auditing standards, which set out the requirements for auditors to follow in the audits of financial statements. In the US, the AICPA (2002) issued the Statement of Auditing Standards (SAS) 82 Consideration of Fraud in a Financial Statement Audit in December 1997. In the UK, SAS 110 Fraud and Error was issued by the Auditing Practice Board (APB) in January 1995.

As shown in figure 2.1, misstatements in financial statements, which are accounting irregularities, appear across an error–fraud continuum. That means accounting irregularities are part of a continuum from low levels of non compliance with standards to outright fraudulent financial reporting (Smaili and Labelle 2009). At one end of the spectrum, accounting irregularities are misstatements caused by unintentional mistakes or errors causing material or immaterial misleading information. Financial restatement is usually the consequence for a listed company that has submitted such a report. At the other end of the spectrum, accounting irregularities are known as fraud, involving those charged with governance (management fraud) or only employees of the entity (employee fraud). The main factor that differentiates error from fraud is whether the underlying action that results in the accounting irregularities is unintentional or intentional.

Unintentional misstatement in financial statements, or error, is the lowest level of accounting irregularity. Those preparing financial statements are most likely to try to

reissue published figures with errors removed. Examples of accounting errors are included as follows (Kwok 2005):

- a mistake in the gathering or processing of data from which financial statements are prepared
- an incorrect accounting estimate arising from oversight or misinterpretation of facts
- a mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.



**Figure 2.1 Spectrum of accounting irregularities**

Source: developed from APB (1995) and AICPA (2002)

Two types of accounting irregularities are of most concern to auditors – misstatement resulting from fraudulent financial reporting (misleading financial statement) and misstatement resulting from misappropriation of assets (theft). Fraudulent financial reporting, which is the most severe type of accounting irregularity, usually involves intentional misstatement or omission of amounts or disclosures in financial statements to deceive or mislead the users of this financial information. Many prior studies (Abbott, Park & Parker 2000; Beasley 1996; Bedard, Chtourou & Courteau 2004; Persons 2006; Uzun, Szewczyk & Varma 2004) have found that fraudulent financial reporting generally involves notions of accounting irregularities, such as:



- manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared
- misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information
- Misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure.

The other type of fraud is asset misappropriation. This involves theft of a corporation's assets. This type of fraud may be accomplished in ways such as: stealing tangible or intangible assets; embezzling receipts; or causing the corporation to pay for the purchase of non-existent goods and services. Misappropriation of assets is usually supplemented by false documents in order to conceal the fact that the assets are missing, thus causing accounting irregularities in financial statements.

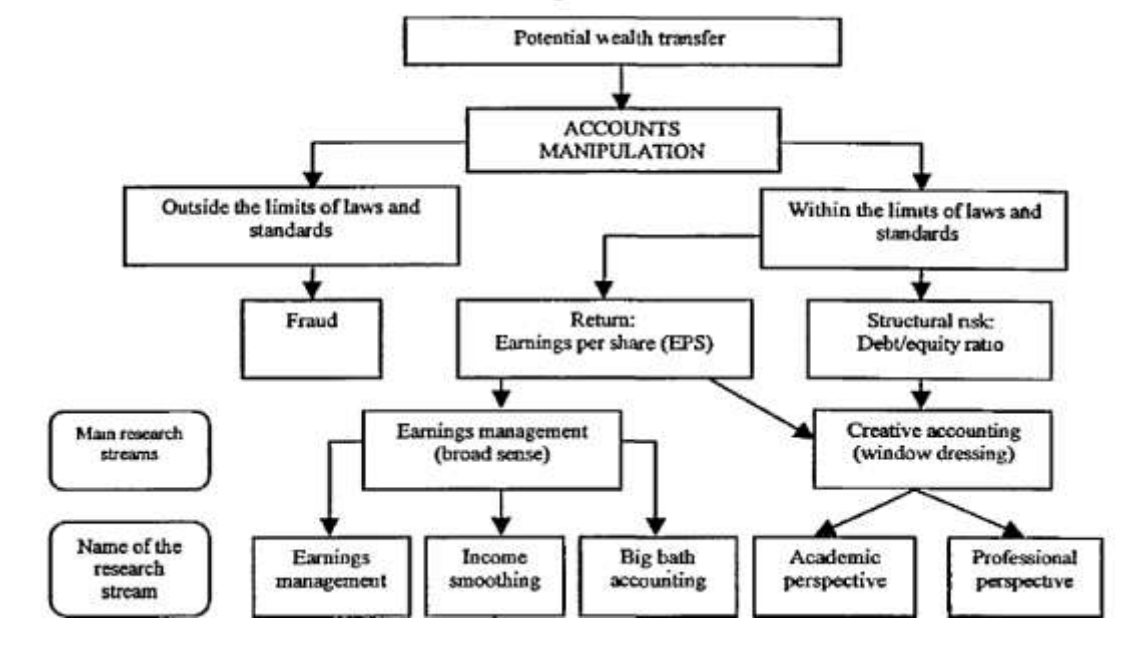
Fraud, to a large extent, occurs when somebody commits an illegal act. In accounting notions, for example, fabricating a false invoice to increase revenue is fraud, while interpreting consignment sales as ordinary sales is error. It can be concluded that fraud exists when account manipulation occurs outside the limit of the regulations (law and standards). Fraudulent financial reporting is a clear example of accounting irregularity (Smaili & Labelle 2009).

A study done by Stolowy and Breton (2004) considers the issue of account manipulation. Account manipulation ranges from within and outside the law and standards. The authors classify this as fraud if the manipulation is done outside the law and standards (known as corporate fraud or financial fraud). However, activities covered by the terms earnings management (such as income smoothing) and creative accounting (or window dressing) normally remain within the regulations. Figure 2.2 presents that framework for understanding account manipulation.

Furthermore, accounting irregularities are distinguishable from earnings management in respect of the acceptability of accounting treatment under the GAAP. Accounting irregularities can arise from either errors or fraud. Earnings management is account manipulation done within laws and standards. Accounting irregularities can start out

small as earnings management, and grow over time to become more severe fraudulent financial reporting.

The concept of earnings management has a broad sense, and it is difficult to provide a single useful and agreed-upon definition. The important thing is that, when manipulation is done within laws and standards, it is categorised into earnings management and creative accounting. The objective of these account manipulations is to alter the wealth transfer mechanism: earnings per share (EPS on income statement side) and debt-to-equity ratio (balance sheet side). Based on Figure 2.2, earnings management is done by manipulating the income statement in two ways: firstly, by presenting items before or after the profit used to calculate EPS; and secondly, by removing or adding particular revenues or expenses (modification of total net income).



**Figure 2.2 Frameworks for understanding account manipulation**

Source: adopted from Stolowy and Breton (2004, p.8)

In addition, ‘creative accounting’ has been developed mainly by practitioners and commentators on market activity (Stolowy & Breton 2004). Some analysts’ concern comes from observing the market, not from any fundamental analysis. Windows dressing activities are done by manipulating structural risk to influence the level of a

firm's debt-to-equity ratio: for example, interpretation of off balance sheet transactions such as leasing.

Earnings management can be beneficial, neutral or pernicious (Ronen & Yaari 2006). Earning management could be beneficial when it signals the long-term value of the company. Managers take advantage of flexibility in the choice of accounting methods to signal internal information on the company's future cash flow. It can be neutral when it reveals a firm's short-term true value. Managers can choose the accounting treatment in a way that is economically efficient, or opportunistic behaviour. Conversely, earnings management can be pernicious, since it conceals short- or long-term performance. This practice usually involves tricks to mislead or reduce the transparency of the financial information.

The US Securities and Exchange Commission (SEC) has stated its concern about earnings management (Levitt 1998) and one scholar questions the capacity of audit committees to deal with earning management that uses accounting tricks to camouflage a firm's true operating performance (Warrick 1999). As a result, account manipulation that is done outside laws and standards constitutes a serious case of accounting irregularities.

#### **2.4.1.1 Gravity of accounting irregularities**

Regarding the gravity or severity of the incidences of accounting irregularities, previous studies have concentrated on binary measurement, such as fraud–non-fraud firm comparisons, and ignore the variety of accounting irregularities in the error–fraud continuum (Abbott, Parker & Peter 2004; Beasley 1996; Sharma 2005). In order to measure the level of seriousness of accounting irregularities, the concept of law enforcement tracking has been introduced by Smaili and Labelle (2009). They are early proponents of the need to have specific measurement of the level of seriousness in accounting irregularities.

The severity of accounting irregularities acts may be tracked by using the level of law enforcement action of a country's securities exchange commission (Kaplow & Shavell 2002; Polinsky & Shavell 2007). In general, the theory of public enforcement of law

posits that an individual (or a firm) chooses whether to commit an act that causes harm with a certainty. For instance, if they commit the act, they will obtain some gain and, at the same time, face the risk of being detected, caught, found liable and finally be sanctioned. Here an individual who guides a harmful act is motivated by an expected utility calculation, such as in economic rationality. They will commit the act if that will raise their expected utility by taking into account any gain they will receive and the probability of cost, form and level of sanction that they would then face (Kaplow & Shavell 2002; Mayangsari & Sudibyo 2005; Polinsky & Shavell 2007).

To illustrate this point, Smaili and Labelle (2009) connect the legal matter of fraudulent behaviour to the error–fraud continuum of financial reporting practices. The Ontario Securities Commission (OSC 2011) publishes a shame list identifying reporting issuers in default (RID). The RID is assessed according to its nature and seriousness and which cases are referred to the proper ‘law enforcement’ institutions. The level of RID seriousness might be traced by using the above law enforcement status.

## **2.4.2 Theories underlying accounting irregularities**

There are some theories that help in explaining and predicting the occurrence of accounting irregularities. In the professional literature, the “fraud triangle” (Montgomery et al. 2002) is regarded as the tools to recognise this unethical behaviour. Furthermore, the term “fraud diamond” (Wolfe & Hermanson 2004) considers a fourth element in addition to the fraud triangle. Stockholder theory and attribution theory are among theories in finance and psychology explaining the cause of such unethical conduct. Detailed discussion is addressed as follows.

### **2.4.2.1 Fraud triangle and fraud diamond dimensions**

The literature on financial misstatement, which is accounting irregularity, concentrates on financial statement frauds. The term “fraud triangle” was introduced into the professional literature by the AICPA in Statement of Accounting Standard (SAS) No. 99 as superseding SAS No. 82, Consideration of Fraud in a Financial Statement Audit. The theory consists of three conditions usually present when fraud occurs: pressure/incentive; opportunity; and rationalisation (Montgomery et al. 2002; Wells

1997). According to this concept, a financial statement fraud is more likely to occur when someone (corporate executives or employees) has an incentive to commit fraud, while weak oversight provides opportunity for those people, and at the same time they might rationalise unethical behaviour.

There must be a strong motivation for the firm to adopt an aggressive unethical accounting policy, since if detected this can be tremendously costly for managers and the corporation. Pressure/incentive or motive reflects the factors that arise and lead to a particular behaviour. This issue represents the answer to the question of why and explains the reason or purposes for accounting irregularities (2003). The author argues that a firm may commit an extreme fraud when the managers and/or the corporation have a strong economic need to report results more favourable than they would be if they followed GAAP guidance.

Wolfe and Hermanson (2004, p.8) believe “that the fraud triangle could be enhanced to improve both fraud prevention and detection by considering individuals’ capability given the presence of the other three elements”. For instance, a company may have internal controls that allow revenues to be recorded early by changing the sales dates in a computerised system. Obviously, there is an opportunity. Furthermore this could be a more serious problem when a CEO is under intense pressure to increase sales figures. In the absence of this kind of CEO, the fraud triangle situation will never become reality. Hence, a major aspect in determining whether a control weakness will lead to fraud is the CEO’s capabilities. This capability obviously can open the doorway to reality. Therefore, an overview of pressures, opportunities, attitude/rationalisation and also individual capability can be examined to determine whether the risk of accounting irregularities has increased.

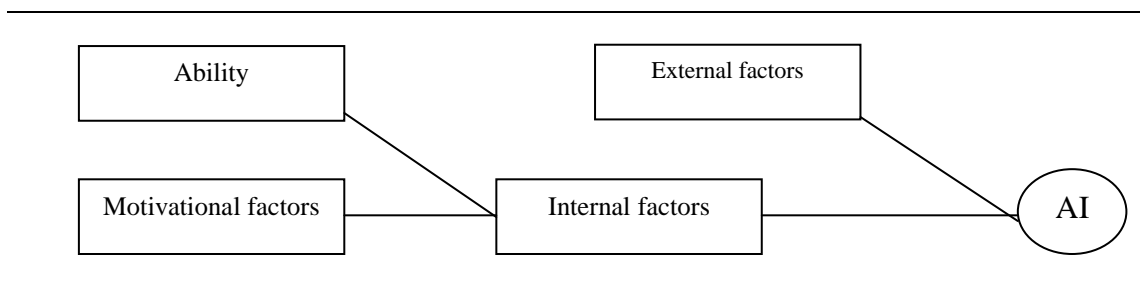
#### **2.4.2.2 Attribution theory**

Attribution theory suggests something like how much an outcome can be attributed to internal factors and external factors (Heider 1958). The theory has been used in many other research areas: management to estimate performance (Kaplan, SE & Reckers 1985), marketing to explain consumer behaviour (Burnkrant 1975), criminal justice

(Greenberg & Ruback 1982), auditing (Bonner, Palmrose & Young 1998) and many more. Attribution theory could be used to analyse the cause of accounting irregularities. An excellent illustration of the attribution theory is applied to the case of individual behaviour by Hinder (1958, p.82):

Consider the example of a person rowing a boat across a lake. The following is but a sample of expressions used to refer to factors that are significant to the action outcome. We say. *“He is trying to row the boat across the lake,” “He has the ability to row the boat across the lake,” “It is difficult to row the boat across the lake,”.... “Today there is opportunity for him to row the boat across the lake,” “It is sheer luck that he succeeded in rowing the boat across the lake”.*

These varying statements have reference to personal factors (i.e., trying, ability and difficulty) on the one hand and to environmental factors on the other (i.e., opportunity and luck).



**Figure 2.3 Framework of an action outcome**

Source: developed from Hinder (1958, p.83)

These aspects can be applied in the case of accounting irregularities and, thus, the framework that is used is Figure 2.3. Just as with individual behaviour, the case of accounting irregularities (AI) incidence at a particular corporation is not much different. Inherent factors of the company, such as its governance reputation and internal control mechanisms, are regarded as internal factors that deter or further the level of harmful acts in financial reporting (Denis 2001), whereas external attribution suggests factors that come from outside the company. The external factors could be the quality of auditing and/or country law enforcement. In a poor law enforcement country, it is likely increase the behaviour of presenting misleading information (Gaviria 2002; Shleifer & Vishny 1993).

Previous literature (see, for example, Bonner, Palmrose & Young 1998; Palmrose, Scholz & Wahlen 2004) has used attribution theory to analyse fraud occurrence and independent auditor responsibility. An auditor is more likely to be judged responsible for failing to detect either commonly occurring accounting irregularities or those that stem from fictitious transactions, since these fraud types are classified as being within auditors' detection knowledge (or ability). When the frauds committed do not include ones that have frequently occurred, or by way of a fictitious transaction, the blame is less likely to be auditors' responsibility. In other words, it could be a wrongdoing caused by a board member, poor corporate governance or other situational factors.

### **2.4.3 Detecting tools**

With regard to the various accounting irregularities, each different type of financial misstatement has a different red flag. This red flag is important to detect the likelihood of this incident occurring. Internal and external auditors are well positioned and qualified to identify red flags (warning of irregularities) and to develop risk models to detect these acts (Rezaee & Riley 2010). Internal auditors potentially have a good position to assess and identify the symptoms of irregularities due to their involvement in routine management activities. Generally, the detection may use qualitative or quantitative approaches.

#### **2.4.3.1 Qualitative tools**

Incorporating the fraud dimension, many researchers have investigated the tendencies of firm committed accounting irregularities by evaluating the qualitative characteristics. Poor corporate governance is blamed as the most likely cause of such accounting irregularity incidences. In order to effectively detect the likelihood of an incidence, it is important to consider the red flags in the firm having the opportunity to commit a various level of accounting irregularities.

A proper focus on the red flags can help in exploring the underlying causes of accounting irregularities. Qualitative symptoms are important pieces of evidence for signalling the likelihood of such incidences. Bourne (2008) has developed a research model that explicitly translates opportunity in fraud theory as the level of corporate

governance index (Brown & Caylor 2006) in predicting a fraudulent financial reporting. This study investigates the dimension of corporate governance that relies on audited information and other information provided by a company for governance analysis, instead using the corporate governance score. In addition the other aspects of fraud theory, such as pressure and rationalisation, are categorised as quantitative symptoms (see 2.4.3.2 for detailed discussion).

In a recent study (Rezaee & Riley 2010, p.109), the possible symptoms of accounting irregularities are listed in three general categories: (1) organisational structures; (2) business and industry environments; and (3) financial conditions. An organisational structure weakness includes culture characteristics and corporate governance implementation. Inappropriate 'tone at the top' and ineffective corporate governance mechanisms are the real red flags of such misstatement behaviour. Business and industry environmental red flags take account of economic downturn situations, industry pressures and regulatory clues. The last category is financial conditions of a particular firm related to its business development, revenue and earnings, transactions and balance sheet characteristics. Elliot and Willingham (1980) posit that red flags do not indicate the presence of fraud; however, they are conditions that commonly present in the event of accounting irregularities.

#### **2.4.3.2 Quantitative tools**

When fraud theory study is evaluated, there are some financial symptoms or indicators of the likelihood of accounting irregularities. Some scholars use quantitative methods such as using financial statement data to identify factors associated with incidences of accounting irregularities. Weak solvency, weak liquidity, high leverage, overcapitalisation and weak profitability are found to be strongly related in fraud cases (Dechow et al. 2010; Magrath & Weld 2002; Persons 1995). Other studies investigate cash flow that are not correlated with earnings, accounts receivable not related to revenues, allowance for bad debt not related to accounts receivable and earnings that consistently meet analysis expectations (Mahoney & Carpenter 2005; Rosplock 2001; Weld, Bergevin & Magrath 2004; Wells 2003).



In particular, Person (1995) uses financial data that is publicly available and predicts accounting irregularities tendencies. Using a step-wise logistic model, there are four important financial aspects found to strongly explain these incidences. These are: financial leverage (total liabilities/total assets); asset composition (current ratio, receivable/total assets and inventory/total assets); capital turnover (sales/total assets) and the book value of a firm, which are all statistically significant in relation to accounting irregularities. This present study uses financial ratios such as leverage, profitability and firm size. Asset composition, as mentioned earlier, is not included. This is due to the research samples ranging from services to manufacturing companies.

## **2.5 An effort to prevent accounting irregularities**

The above sections have discussed the qualitative and quantitative tools to detect the likelihood of such accounting irregularities. This section reviews how corporate governance mechanisms should be implemented to safeguard investors' and other stakeholders' interest in a particular company. Other prior research findings have also uncovered the influence of external factors such as outside block holders' ownership, indebtedness, poor financial performance and company.

### **2.5.1 Role of corporate governance mechanisms**

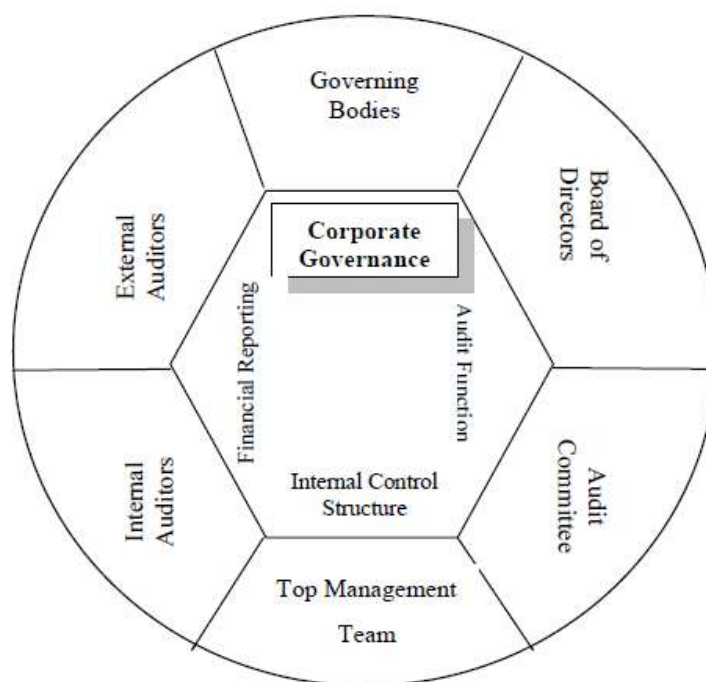
Corporate governance plays a fundamental role in improving the efficiency of the stock market through its impact on company operating efficiency and effectiveness, growth opportunity, as well as integrity and quality of annual report. Rezaee and Riley (2010, p.123) mention that:

No corporate governance would be necessary if management acted in the best interest of shareholders and if corporate gatekeepers (board of director, lawyers and accountants) effectively discharged their fiduciary duties and professional responsibilities. Corporate governance is needed to avoid concentration of power in the hands of management and to create an effective system of checks and balances to appropriately balance power-sharing authority among shareholders, board of directors, management, and, to a lesser extent, other stakeholders.

Corporate governance as an information system tool should be employed to monitor the interests of investors and creditors, or capital providers, by evaluating the allocation of

investment for a maximum return, assessing the risk associated with the investment and continuously monitoring the administrative matter of the investment.

According to Figure 2.4, corporate governance participants are the board of directors, the audit committee, the top management team, internal auditors, external auditors and government governing bodies. This structure should ensure that those who manage corporate resources, such as the top management team, are monitored and held accountable in spending the resources in an efficient and effective manner.



**Figure 2.4 Corporate governance and its functions**

Source: Adopted from Rezaee and Riley (2010, p.123)

Regarding the role of preventing accounting irregularities, three aspects of corporate governance systems are important. To a large extent, transparency, competence and integrity, and an effective system of checks and balances are among the corporate governance principles that directly have an impact on minimising financial statement fraud. First, the transparency feature ensures financial reports are understandable and reflect the economic reality of the company. Second, the effectiveness of corporate

governance depends on the degree of integrity and competence of those who carry out key functional responsibilities. Lastly, the existence of an effective system of checks and balances ensures a proper alignment of interest and role division among shareholders, boards of directors and the top management team.

#### **2.5.1.1 Board of director monitoring effectiveness**

In a one-tier board system, the board of directors consists of a number of executive and independent directors. As an illustration, the US board of directors probably best describes the mechanisms for preventing the concentration of power in the hands of a few members of the executive management and for creating checks and balances mechanisms. The board's authority is given by the shareholders to hire and to monitor top management plans, decisions and actions.

Previous studies have found that the board of directors plays a crucial role in establishing the credibility of the financial statement and safeguarding against misbehaviour in this reporting process. Among earlier studies, Dechow et al. (1996) investigates the US companies that are increasing their earnings by violating the GAAP. By comparing with another 92 firms that comply with GAAP, it is found that firms that violate GAAP have a higher proportion of insider directors or executive directors on the board and are less likely to employ an audit committee than firms not violating GAAP. Dechow et al. were concerned with load factors which they named "low oversight management" and "power of CEO over the board". Low oversight management has positive statistical significance associated with earnings manipulation.

Beasley (1996) investigates several attributes of boards of directors and the incidences of financial statement fraud. He examines 75 fraud firms and compares these with another 75 no-fraud firms to determine whether firms experiencing fraud are more likely to have a lower number of independent or outside directors than no-fraud firms. Moreover, the effect of independent directors is stronger than that of outside directors on the board. An independent director is supposed to be more vigilant, since they are believed to be 'truly' independent from the management of the company. The author

argues that outside directors have no affiliation relationship other than a relationship of being a member of the board.

In order to answer his research question, Beasley (1996) examines the data one year prior to the incidences of fraud. Among other things, his study includes some control variables such as financial performance (distressed), firm growth, listing tenure, management ownership, CEO tenure, duality and cumulative percent of block holding (unaffiliated shareholding more than 5% of total shares). However, Beasley's study does not mitigate the effect of accounting flexibility influenced by audit quality (see, for example, Becker et al. 1998; Peasnell, Pope & Young 2001).

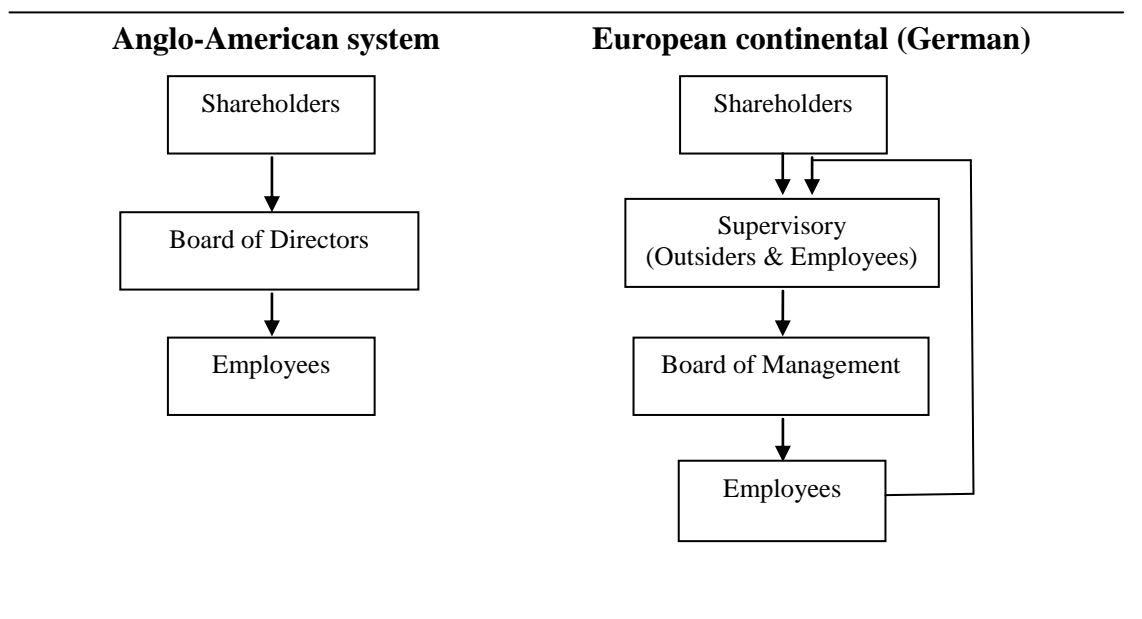
Moreover, in a UK study, Peasnell, Pope and Young (2001) investigate corporate governance characteristics of firms subject to adverse rulings by the Financial Reporting Review Panel (FRRP). This panel performs enforcement roles similar to the SEC with regard to the Accounting and Auditing Enforcement Releases (AAER). Companies without an audit committee, companies with fewer outside directors and a CEO in the chairman role, and those not employing 'big five' auditors were more likely to violate accounting regulations. For this reason, this study considers that corporate governance structure plays an important role in controlling misreporting behaviours that could jeopardise companies and their shareholders.

In a more recent study, Smaili and Labelle (2009) examine the board of directors' effectiveness in monitoring top management reporting behaviour. The literature on fraudulent financial reporting, restatement and quality of financial reporting generally indicates that the composition and characteristics of the board influence its monitoring effectiveness. The results of these studies advise that the tendency toward accounting irregularities is associated with the board's power, competence and independence (Abbott, Parker & Peter 2004; Beasley 1996; Beasley et al. 2000a; Farber 2005).

While the composition and characteristics of effective board monitoring in the Anglo-American context is rather similar, the result may not be generalisable to the two-tier board structure. For instance, this type of board is practised in Germany, Austria,

Holland, Finland, Denmark, Estonia and France<sup>1</sup>. Therefore, there are questions of how the composition and characteristics of the two-tier board structure are commonly applied in some continental European countries to prevent the likelihood of accounting irregularities.

In a two-tier board structure, there are twin boards often made up of a supervisory board and a management board. The supervisory board has only independent members; none of them is an executive director. The supervisory board conducts itself in a similar way to a board of directors in a one-tier board system. The roles of the supervisory board are: (1) approval and evaluation of strategy and policies; (2) monitoring company performance and accounts; and (3) appointment or dismissal of the management board, which is monitoring the board's performance. Proponents of this board structure argue that supervisory or watchdog boards ensure that directors do not set, mark and report their own exam papers.



**Figure 2.5 Comparisons of corporate structures**

<sup>1</sup> In Asia, this two-tier governance structured is also practised in Indonesia, where supervisor boards and management boards are called boards of commissioners and boards of directors, respectively. This legal structure is due to the historical connection between the Dutch and Indonesia from the colonial era to 1945 Indonesia independence. *See chapter 3 for detailed information.*

Turning to the management board, it consists of executive director members only. This board has a similar role to the top management team, such as the CEO and other functional executive directors, in a one-tier board system, but none of them is represented in the supervisory board. The role of the management board is mainly: (1) operations and running of the company; (2) entrepreneurship; (3) compliance with statutory requirements; and (4) regular reporting to the supervisory board on strategy, accounts and performance.

Supporters for the two-tier board argue that this type of board structure may perform better where shareholding is not as atomised and diversified as the Anglo-American systems. Co-determination, employees' inclusion in a supervisory board, constitutes a strong stakeholders concept, as practised in Germany and other advanced European economies. This approach is more societal-oriented, with respect being paid to the interest of other constituents. In addition, practising a two-tier board structure also differs across countries. In Germany, the supervisory board exerts substantial independent influence on management (de Jong et al. 2005), whereas in the Netherlands there are no employee members on the supervisory board and there is a close relationship between management and the supervisory board so as to include the management board's influence on the appointment of the supervisory board.

#### **2.5.1.2 Audit committee monitoring effectiveness**

Misleading financial reporting is more likely to happen in a company with ineffective audit committees. Levitt (1999) testifies that there are audit committees that lack expertise in the basic principles of financial reporting and are unable to ask probing questions. He continues a case of an audit committee that convenes only twice a year before a regular board meeting for 15 minutes and just listens to a perfunctory presentation. A recommendation for current practice is cited as “an effective oversight of financial reporting process depends to a very large extent on strong audit committees. Qualified, committed, independent and tough-minded audit committees represent the most reliable guardian of the public interest” (Levitt 1999).

At first, many companies established audit committees of outside directors to monitor the quality of financial reporting process, internal control structure and audit function. Recently, the SOX Act of 2002 and the SEC's related implementation rules (SEC 2003) require empowering audit committees to function on behalf of boards of directors by playing significant roles in the corporate governance process to ensure corporate accountability and protect the investors' interest. This new capacity requires audit committees to oversee the effectiveness of corporate governance, integrity of financial reports, adequacy of internal control structure and quality of the external audit function.

As depicted in Figure 2.4 earlier, approved new guidelines have shifted the role of audit committees to enhance the integrity and quality of financial reporting reports and consequently contribute to preventing and detecting financial statement fraud. To illustrate this point, the primary responsibilities of audit committees according to the SOX Act of 2002 are to: (1) oversee the accounting and financial reporting processes of listed companies; (2) oversee the audits of financial statements of the company; (3) ensure internal controls are designed, implemented and operated effectively to safeguard the company's assets through interaction with internal and external auditors; and (4) appoint, compensate, and oversee the work of an external auditor employed by a listed company (Sharma 2005).

As part of discharging the above responsibilities, review of the effectiveness of internal control and reliability of financial reports is essential. The audit committee should review the adequacy and effectiveness of overall, general and specific internal control, not focus only on internal control over financial reporting (ICFR). The review undertaken has to be publicly reported. Rezaee and Riley (2010) clarify that audit committees should review: (1) management's assessment of the effectiveness of ICFR; (2) the independent auditor's report on the effectiveness of ICFR; and (3) the independent auditor's opinion on the fair presentation of financial statements.

Components of effective audit committees have evolved over the years. They began with Blue Ribbon Committee (BRC 1999) recommendations in the US and developed as more recent rules of securities exchange commissions and some organised stock

exchanges. It is now viewed that the committee functions as an overseeing role of corporate governance, financial reporting process, internal control structure and audit function. However, there has not yet been a common view of an effective audit committee and about including committee reports in annual reports. This limitation exists due to the fact that: (1) management is primarily responsible for the fair presentation of financial statements; (2) auditors are responsible for providing assurances regarding financial statement; and (3) audit committees are not adequately resourced and staffed to shoulder the onerous legal responsibility of ensuring the reliability of financial statements (Rezaee & Riley 2010).

Some studies, such as Dezoort et al. (2002) and Bedard, Chtourou and Courteau (2004), theorise that effective audit committees are dependent on the attributes of their composition, authority, resources and diligence. Effective audit committees have qualified members with the authority and resources to protect stakeholders' interest by ensuring reliable financial reporting, internal control and risk management, and appointment of competent auditors through their diligent efforts. That is why audit committees need to be independent and have members with sufficient financial expertises, authority to act and resources for timely access to the necessary information, including direct contact with internal and external auditors, in order to have a strong base for being effective.

Regarding members' independence, the US rule requires "each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent"<sup>2</sup>. In order to be independent:

- Audit committee members must be barred from accepting any consulting, advisory or compensatory fee from the issuer or any subsidiary, other than in the member's capacity as a member of Board or any board committee, such as nomination and remuneration committee.
- An audit committee member must not be an affiliated person of the issuer or any subsidiary apart from capacity as a member of the Board or any board committee.

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<sup>2</sup> This statement mandates that audit committee members should be composed entirely of independent members of boards of directors. See more on the Section 301 SOX Act of 2002 as amendment of Section 10A (m) (3), the Securities Exchange Act of 1934 concerning Audit Committee Independence.



In addition, being financially literate is required for all members of the audit committee. This means they must have a basic understanding of accounting, finance and business issues. At least one member shall have financial expertise, such as in accounting or related financial management education. These competencies are needed to address all critical accounting policies and practices used by management.

Particular resources are needed to enable audit committees able to be effective. Information access to management and staff is considered necessary. Its responsibilities also require unrestricted access to company records and financial reports. The committee is also able to hire accounting, financial and legal advisors, in case there is a specific issue too hard to solve internally. Last but not least, the audit committee has to be adequately compensated (e.g. in cash or stock).

Exercising audit committee duties is another aspect of being effective. Since committees' responsibility varies from internal control to the financial reporting process, the audit committee needs to meet frequently. Audit committee effectiveness is a function of its diligence (Kalbers & Fogarty 1993). The number of meetings is used as a proxy for diligence (DeZoort et al. 2002; Menon & Deahl Williams 1994). Sharma (2005) states that an audit committee that meets frequently (with both internal and external auditors) can reduce the incidence of accounting irregularities in two ways. Firstly, meeting with an internal auditor can make an audit committee more knowledgeable and informed about accounting and auditing issues. Second, a meeting with an external auditor could direct additional audit resources in a timely manner for particular issues. This could lessen year-end audit pressure and reduce the likelihood of compromising on poor audit quality.

#### **2.5.1.3 Management and internal auditor responsibility**

Management also plays an important role in making sure of effective and responsible corporate governance by appropriately managing the business of a corporation to create shareholders' value. Through its mandated authority from a board of directors, management is supposed to be responsible for executing corporate strategies, utilising resources effectively, directing and coordinating operational activities and safeguarding

a company's assets. For example, after the SOX Act of 2002 in the US, a firm's management is responsible for certifying the effectiveness of internal control over financial reporting (ICFR), in addition to the completeness and accuracy of financial statements.

Although the accounting disciplines and corporate governance have a long history of examining aggressive accounting practices, previous research has predominantly focused on the antecedents of firm-level characteristics, such as financial situation and governance mechanisms such as the board of directors (Beasley 1996; Beasley et al. 2000a; Uzun, Szewczyk & Varma 2004), audit committee (Abbott, Park & Parker 2000; Abbott, Parker & Peter 2004; Carcello & Neal 2003; DeZoort et al. 2002; Sharma 2005), quality of auditor (Becker et al. 1998; Francis 2004; Tirta & Sholihin 2009) and other antecedents at the industrial level. However, the 1999 Committee of Sponsoring Organisations of Treadway Commission (COSO), which investigated the key factors influencing firms subject to enforcement action for fraudulent financial reporting, concluded that the CEO and the Chief Financial Officer of the firms were actively involved in most of these cases (Beasley et al. 2010; Beasley, Carcello & Hermanson 1999).

There are many studies to date examining the effect of CEO stock ownership (or stock-based executive compensation) and CEO tenure on an aggressive earning management. The usage of stock-based compensation is consistent with agency theory, which advocates employing such compensation as a way of aligning executives' self-interest with the interest of shareholders (e.g. Eisenhardt 1989). However, executives with high equity incentives are more likely to sell shares later on and to engage in earning management to increase value of the share to be sold (Cheng & Warfield 2005). In addition, such compensation or even stock ownership could make the executives' position that of an investor and executives' perception of compensation risk will be perceived as threats to their wealth (Zhang et al. 2008). As a result, CEO may be highly motivated to manipulate reports of financial statements in order to grab capital gain and to avoid financial drawbacks.

An upper echelons theory suggests that longer-tenured CEOs are less likely to respond to increasing external pressures with risky behaviour (Dunn 2004; Hambrick & Mason 1984). As executives build trust in senior ranks, they tend to sacrifice most of their energy to maintain their status quo. Therefore, longer-tenured CEOs may be less keen to engage in unethical behaviour that could destroy their established reputations (Gray & Cannella Jr 1997). In the other hand, recently appointed CEOs may have less to lose and take chances in order to build their personal wealth. Consequently, they may respond to negative situations (e.g. financial distress) by engaging in self-serving or even illegal fraudulent financial reporting.

Accordingly, researchers in this field have identified additional executive characteristics in association with the kind of accounting irregularities. It is the chief financial officer (CFO) whose primary responsibility is financial reporting. The CFO should play a stronger role in such accounting irregularities, rather than the CEO (Hennes, Leone & Miller 2008; Xuefeng Jiang, Petroni & Yanyan Wang 2010). In most cases, the CFO is also a member of the board of directors and directly works on reporting matters. Eventually, their perceptions of an external negative pressure or other self-serving motivation tend to have a greater magnitude of accrual and increase the likelihood of accounting irregularities.

Having examined the above executives' characteristics, it is important to note that there is a different perspective on executives in a two-tier board structure. While the CEO or CFO is mostly involved in directorship positions as a member of a board of directors, executives in two-tier board systems are separated from the oversight role conducted by the board of commissioners. Therefore, applying executives' characteristics from the one-tier system to find ways of reducing accounting irregularities may not be appropriate, since in such circumstances the CEO or CFO is a member of a board of management that is responsible to a board of commissioners regarding daily routine managerial activities, including internal control and financial reporting.

This present study is using dimensions of boards of management from a two-tier board structure, as practised in Indonesia. For example, NCG (2006) has indicated the

effective principles for boards of management. Among other things, the Code provision requires that: (1) the composition of the board of management shall be of sufficient size that suits the complexity of the business; (2) the members of boards of management must be professional in terms of capability and integrity; and (3) the role of boards of management shall cover main tasks, including ICFR.

In extending the role of the top management team in preventing accounting irregularities, the existence of an effective internal auditor is a cornerstone (Doyle, Ge & McVay 2007). After the enactment of the SOX Act of 2002, internal auditors have been actively involved in ensuring top management teams undertake proper compliance with the provision of regulations, particularly related to internal control, risk assessment and financial reporting. Therefore, further evaluation of board of management characteristics, including existence of an effective internal auditor, is needed to understand why they may be engaged in accounting irregularities and to find ways to anticipate this socially unwanted behaviour.

#### **2.5.1.4 Auditor effectiveness**

The auditor plays a prominent role in preventing and detecting accounting irregularities (Smaili & Labelle 2009). With regard to the corporate governance mechanism, independent auditors act as an external mechanism, since they review and evaluate a firm's internal control and program audit plan to detect any material misstatement. Users of audited financial statements traditionally have held external auditors responsible for detecting accounting irregularities. However, independent auditors, in accordance with their professional standards, provide only reasonable assurance (not an absolute assurance) that financial statements are free of material misstatements caused by error or fraud. Therefore, a modified audit report is really a matter for financial statement users.

It is useful to consider the audit risk regarding accounting irregularities. Synthesising statistical theory, accounting irregularities come about from both type I and II statistical errors. In the first type of errors, the auditor is modifying their opinion for clients that do not subsequently fail or otherwise in negative situations. The second type of errors

constitute that the auditor is issuing a clean unqualified opinion when there is an irregular item on a firm's financial statement. When those two types of errors are uncovered, financial statements are required to be restated or even investigated.

Previous studies have discovered audit quality negatively associated with the degree of accounting irregularities (Farber 2005; Turner & Sennetti 2001). It is accounting firm size for a proxy of quality (i.e. auditor independence) since a large auditor has a greater reputation to lose if they misreport (DeAngelo, L 1981). This first wave of big-small firm dichotomy studies was continued until the end of the 1980s. In the beginning of the 1990s, Knapp (1991) proposed the length of the auditor-client relationship (or audit tenure) as a complement of audit quality dimension.

There is debate about whether audit tenure reduces external auditor independence. On the one hand, self-regulatory bodies in auditing tend to argue that a lengthy association between auditors and their client can impair independence. Familiarity and personal ties could develop between them, which may cause less vigilance over clients' top management (Piot & Janin 2007). For that reason, the audit engagement could be just a routine over time, and if this happens, the auditor will dedicate less effort to recognising the weaknesses of the auditee's internal control, leading to a neglect of risk sources. On the other hand, the robustness of mandated audit rotation is questionable, since audit tenure reduces abnormal accrual, whether positive or negative (Myers, Myers & Omer 2003). Another study by Geiger and Raghunandan (2002) has found that the likelihood that a going-concern audit report is issued prior to a bankruptcy filing is a positive function of auditor tenure. This means, conversely, that the quality of auditor reporting improves over time.

Smaili and Labelle (2009) investigate the effect of auditor change on audit quality. The likelihood that auditors will detect an anomaly increases in the first years of engagement, and then decreases step by step (Knapp 1991; Piot & Janin 2007). Furthermore, a change in auditor caused by a referral may constitute a better level of audit quality (Branson & Breesch 2004). Hence, as a whole, a change in auditor and a

referral situation taking place constitute positive reinforcement of the idea of audit rotation and is proposed to improve audit quality.

In relation to financial misstatements, efforts to restore investors' confidence recommend that audit quality does not solely lie with the external auditor, but also includes an oversight role by the audit committee (Piot & Janin 2007). In the US, this reaction is expressed by challenging the self-regulation of the accounting profession (AICPA) and has been created by a law of the Public Company Accounting Oversight Board (PCAOB)<sup>3</sup> and by more restrictions on audit committee requirements (e.g. SOX Act, Section 301 and 407). The Blue Ribbon Committee in 1999 earlier suggested recommending the reliability and credibility of financial statements using diligent interaction between audit committees and a firm's auditors. Subsequently, the US SEC and organised stock exchanges increased their scrutiny on audit committees to oversee management, internal and external auditors. Audit committees' oversight role may be implemented as candid interactions to reduce aggressive earnings management, and to increase the quality of a firm's financial reporting (Bedard, Chtourou & Courteau 2004).

#### **2.5.1.5 Governing bodies**

A country's Securities and Exchange Commission (SEC) is usually a primary regulatory body for regulating public companies. In most cases, this regulatory body has civil lawsuit resources only. To some extent, the commission can also conduct criminal investigations; however, a criminal indictment must be referred to prosecutors. Involvement of the regulatory and enforcement structure related to accounting irregularities can be far-reaching.

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<sup>3</sup> In the early 2000s, federal public policymakers concluded that where independent financial statement audits of public companies regulated by the US Securities and Exchange Commission are concerned, the AICPA's standards setting and related enforcement roles should be transferred to a government empowered body with more enforcement authority than a non-governmental professional association, such as the AICPA could provide. As a result, the SOX Law created the PCAOB, which has jurisdiction over virtually every area of CPA practice in relation to public companies. However, the AICPA retains its considerable standards setting, ethics enforcement and firm practice quality monitoring roles for the majority of practising CPAs, who serve privately held business and individuals.

To illustrate this point, the US SEC requires financial disclosure to provide financial statement users with adequate information in making rational economic decisions. The disclosure requirement by laws and regulations, such as the Securities Exchange Act 1934, were considered necessary to prevent accounting irregularities. Moreover, Pincus, Holder and Mock (1988) in Rezaee and Riley (2010) have conducted a survey and classified the SEC financial statement fraud activities in three different aspects: (1) prevention activities; (2) detection activities; and (3) enforcement activities.

According to the above survey, there are five SEC prevention activities that are believed at least somewhat effective. These activities are: (a) establishment of securities registration requirement; (b) reviewing of registration requirement; (c) establishment of financial reporting requirements; (d) ongoing reviews of quarterly or annual filing and (e) making publicity related to enforcement actions. Among other things, the SEC's most effective fraud prevention activity is publicity related to enforcement actions. On reviewing registrants' filing, the SEC paid more attention to auditor opinions rather than those of the unqualified, auditor change, tips from informants and monitoring market activities as fraud detection tools.

The SEC serious enforcement actions include: to publish Accounting and Auditing Enforcement Releases (AAER) and to create a multi-agency Corporate Fraud Task Force consisting of elements of the SEC and the Department of Justice in July 2002, to combat frauds and other accounting scandals. Apart from investigating suspected corporate fraud, the Task Force is responsible for indicting defendants with civil and/or criminal wrongdoings.

Furthermore, Rezaee (2005) urges the SEC's enforcement procedures to consider the internal fraud handling procedures within a listed company. Perpetrators of severe accounting irregularities, from top executives to employees, must understand that this behaviour is a crime that will be prosecuted. Corporations should adopt no-tolerance policies for fraudulent financial statements. Therefore, any top executives or employees who engage in fraudulent reporting should be dismissed or, alternatively, their

incentives or bonuses should be cancelled if the company has to refile financial statements following the SEC's detections.

### **2.5.2 Corporate governance mechanisms as a system**

There is no consistent evidence to suggest that one governance mechanism is more important than other dimensions. Therefore, the governance mechanism is rather a combined procedure to encourage more accountability and transparency and to increase current and potential investors' confidence. A study conducted by Cohen, Krishnamoorthy and Wright (2004) exemplifies the "corporate governance mosaic" where each dimension of corporate governance interacts to determine the quality of financial reporting. In other instances, they mention that the role of the auditor in the governance process is very complex, as the auditor interacts with other stakeholders, such as the audit committee and the management. In turn, the interplay among the stakeholders is affected by external mechanisms such as regulators and stock exchanges, as well as pressure to meet financial analysts.

Another study (e.g. 2005) suggests an open and candid communication between the board of directors and the representative of audit committees and the auditors, in order to improve the quality of financial reports by focusing on weakness areas that may create potential for fraudulent financial activities. The SOX Act of 2002 also requires that an audit committee oversees auditors in regard to their audit process. Auditors shall also report to the audit committee on the critical accounting policies and practices employed by management. This law requirement is aiming to ensure that the auditor is independent, competent and knowledgeable about general industries and clients' business. The quality of the working relationship between the board of directors, the audit committee and auditor should not negatively influence auditors' independence and objectivity.

In a more recent study, Smaili and Labelle (2009) have hypothesised an integrative model to investigate the effect of corporate governance as a system, rather than only examining its individual dimensions (Abbott, Park & Parker 2000; Abbott, Parker & Peter 2004; Beasley 1996; Carcello & Nagy 2004) on the incidence of accounting



irregularities. The study has found that synergy among governance mechanisms may limit the severity of accounting irregularities. The presumed synergy between the board of directors, the audit committee and the auditor is shown to be a statistically significant influence on the reporting incidences. The finding also notes that the introduction of interaction terms, audit committees and auditors, has increased the explanatory power of the initial individual models. Thus, these studies support consideration of a requirement of diligence interdependency among those involved in corporation oversight roles.

## **2.6 Summary**

The review of corporate governance and accounting irregularities studies indicates that research into financial reporting quality, especially in a two-tier board system, is still in the development stage. This is due to the limitations, problems and inconsistent results inherent in these areas, which have been largely undertaken in a unitary board system, highlighted in this chapter (Bourke 2007; Bourne 2008; Smaili & Labelle 2009). Therefore, this study emphasizes the relationship between the governance mechanism and accounting irregularities in the two-tier board environment, which may not be properly understood.

Previous research on accounting irregularities has concentrated only on one type of irregularity at a time, and has classified the incidence of irregularities but not the gravity of these irregularities. Therefore, the inconsistent results are not surprising. There are methodological problems with estimating the level of accounting irregularities' seriousness, which may appear across an error–fraud continuum (see, for example, Abbott, Park & Parker 2000; Beasley 1996; Kwok 2005; Persons 2006). Further, the concept of fraud triangle, fraud diamond and attribution theory is also highlighted to explain the nature of accounting irregularities cases.

This study seeks to contribute to the literature in a number of ways, one of which is to make a detailed analysis of the relationship between two-tier governance structures and the seriousness of accounting irregularities cases, especially in a setting of developing countries or emerging markets. The two-tier governance structure consist of a board of commissioners (supervisory board), audit committee, management board or so called

board of executive directors, and auditors as one of the external governance. As presumed collaboration is highlighted to improve the effectiveness of corporate governance systems (see Figure 2.4). Further this study investigates the role of governance bodies by using their regulatory law enforcement data to indicate case seriousness. The next chapter presents the recent legal alterations that have been influencing corporate governance and misstatement in financial reporting in Indonesia.

## **CHAPTER 3   INDONESIAN MARKET, CORPORATE GOVERNANCE AND POTENTIAL OF ACCOUNTING IRREGULARITIES**

### **3.1   Introduction**

This chapter reviews the recent legal alterations that have been influencing corporate governance and misstatement in financial reporting in Indonesia. To begin with, there is a brief preview of the Indonesian economy and stock market. The next section presents the key attributes of the Indonesian commercial law framework comprising the new Indonesian Company Law 2007, the Capital Market Law 1995 and the new Investment Law 2007. The next section details corporate governance implementation in Indonesia, which has adopted it. Then the Indonesian accounting system is discussed, which consists of the legal framework, development and reporting requirements. The final part of this chapter reviews issues concerning the relationship between corporate governance practices and accounting irregularities incidences in Indonesia.

### **3.2   The Economy and stock market**

#### **3.2.1   General information**

Indonesia, officially the Republic of Indonesia, is the largest country located in Southeast Asia. The Indonesian archipelago lies between Asia and Australia, with more than 17,500 islands and 5,120 kilometres in length from west to east. The five largest islands are Kalimantan (Borneo), Sumatra, West Papua, Sulawesi and Java. Temperatures range between 20–35 degrees centigrade and the climate is tropical. Jakarta is the capital city and the biggest with more than 9 million in population.

Across the archipelago, Indonesia consists of different ethnicities, numerous local languages and religions. People are mainly of Malay descent and have developed into more than 300 ethnic groups with different languages and accents. Mostly people reside on Java and Sumatra, 58% and 21% of the total population, respectively. It has the

world's largest population of Muslims; the remainder practises Christianity, Buddhism, Hinduism and other religions. There are 237 million people (BPS 2011) and thus it constitutes the world's fourth most populous country. Indonesia has developed a shared identity shown by a national language, religious pluralism and ethnic diversity. "*Bhinneka Tunggal Ika*" is the national motto that literally means "Unity in diversity".

Turning to government and politics, the amended 1945 Constitution of Indonesia has revamped the role of each executive, judicative and legislative element. Indonesia is a republic with a President as the head of state, the chief of cabinet and the commander-in-chief of the Indonesian armed forces. There has been a direct presidential election since 2004. The president is allowed to serve a maximum of two consecutive five-year terms. The Supreme Court (*Mahkamah Agung*) constitutes the country's highest court. People often appear before a State Court and appeals are heard before the High Court. There is a Commercial Court and a State Administrative Court dealing with disputes over business and the public service, respectively. The government has also established a Religious Court to deal with codified Sharia Law cases. The highest legislative branch is the People's Consultative Assembly (MPR) with two houses: the People's Representative Council (DPR) and the Regional Representative Council (DPD). Before the reform following Soeharto's era in 1998, there was an army representation in Parliament before it was replaced by the new chamber for matters of regional arrangement (DPD). The local government is separated into 33 provinces headed by a governor. The provinces are divided into regencies (*kabupaten*) and cities (*kota*).

The country is well gifted in natural resources. Indonesia has geothermal potential, but little is currently used. There is large forest cover with lumber industries. However, illegal logging is a considerable controversy and is shrinking forested areas dramatically. Indonesia is also rich in coal, natural gas and a variety of minerals and is much endowed with a diversity of flora and fauna. Facilities and infrastructure are well developed in anticipating the benefit of the emerging economy of Indonesia.

### 3.2.2 An Indonesian economy

Indonesia has a mixed economy where the government and private sectors simultaneously play significant roles. State-owned enterprises (SOEs) still play a significant role in strategic industries. Moreover, the involvement of the private sector in a variety of industries has been increasing with the open economy since the 1970s and growing dramatically in the 1980s and the beginning of the 1990s. However, the 1998 Asian crisis turned Indonesia's status the other way around. In the aftermath of the 1998 Asian crisis, Indonesia has transformed public and economic infrastructures. Although the problems remain, the economic transformation has helped the country in weathering the 2008 financial crisis very well (Tambunan 2010).

The country has the largest size of economy in terms of gross domestic product (GDP) within its ASEAN counterparts. The GDP in 2009 was more than US\$546 billion with nominal per capita of US\$2,363.6. The estimated value of 2010 GDP was about US\$706 billion with per capita (nominal) of US\$3,015. Indonesia represents the ASEAN countries as a G20 member due to the Indonesian economy and market size. The service sector is the economy's largest and accounts for 47.6% of 2009 GDP, followed by manufacturing (26.4%), agriculture (15.3%) and mining (10.5%). So far, the OECD (2010) points out short-term projections pointing to strong growth determined by domestic market demand.

**Table 3.1 Gross Domestic Product in ASEAN at current prices (nominal)**  
As of 15 February 2011

Country	2004	2005	2006	2007	2008	2009	In US\$ million		
							2010		
							Q1	Q2	Q3
Brunei	7,864	9,527	11,460	12,280	14,450	10,758	–	–	–
Cambodia	5,310	6,250	7,258	8,635	11,073	10,357	–	–	–
Indonesia	255,443	284,790	364,371	431,024	513,032	546,864	161,590	173,216	184,398
Lao PDR	2,517	2,860	3,521	4,127	5,285	5,579	–	–	–
Malaysia	124,749	137,971	157,237	187,112	222,724	193,107	54,491	57,504	61,091
Myanmar	10,369	10,989	13,187	19,131	22,858	24,972	–	–	–
Philippines	86,912	98,757	117,457	146,838	166,443	161,357	42,188	46,038	45,203
Singapore	112,692	125,417	145,071	176,769	193,535	182,701	50,395	54,638	56,947
Thailand	161,385	176,340	207,467	247,095	272,788	264,322	77,814	76,109	78,795
Vietnam	45,544	52,952	60,965	70,964	90,515	96,317	20,120	26,547	27,363
ASEAN									

Source: ASEAN (2010)

Further, SOEs constitute direct government involvement in business. Since the early years of independence in Indonesia, SOEs have had a significant role in political and economic development (Astami et al. 2010). This is in accordance with the Indonesian Constitution requiring that sectors of production that are important and affect the life of the people be controlled by the state. In 2006, there were at least 157 SOEs spread over most industrial sectors, such as manufacturing, construction, financial service and insurance, airlines, power, oil and gas and services. However, the implementation of SOEs has changed over time regarding efficiency and operational effectiveness. Most of the SOEs being evaluated have been rated “not well performed” (Irianto 2004) and, in the following period, the government even decreased willingness to subsidise them due to revenue shortage. The considerable role of the IMF post crisis recovery program has resulted in some of the SOEs still being fully owned by the state and others whose ownership has partially shifted to private sectors.

The Indonesian private sector competes in a relatively open economy. Indonesia has introduced relatively liberal regulations that have regulated domestic and foreign investment since the New Order took position in 1967. The following period was marked with substantial private investment in the industrial sector replacing government investment. Windfalls of oil and gas revenue during the 1970s have promoted industrial development in order to substitute for imports. The industries have been developed to be highly dependent on tariff protection and substantial import-contents. Prior to the Asian crisis, business circulated among a discrete group with special privileges and elite political connection. Indonesia was experiencing being the hardest hit by the crisis; however after seven years post-crisis, a multi-sectors reform has contributed to a trade surplus. The general conditions of business are still dominated by business groups and conglomerates with more presence of both domestic and foreign investors.

### **3.2.3 Indonesian capital market**

The Indonesia Stock Exchange (IDX) is a new trading name due to the merging of the Jakarta Stock Exchange (JSX) and Surabaya Stock Exchange (SSX) in December 2007. The exchange has been established since 1912 under the Dutch colonial government in Jakarta. However, in the early years of Indonesian independence, the bourse was not

active until re-opening in 1977. The IDX was operated by the Capital Market Executive Agency (known as *Badan Pelaksana Pasar Modal* or BAPEPAM), a government agency, which is responsible to the Ministry of Finance. In 1992, the exchange management was handed over to the JSX Inc. due to an increasing number of issuers and market capitalisation. BAPEPAM's role has changed as a supervisory agency<sup>4</sup>. Meanwhile, the SSX was officially opened in 1989 to encourage the development of capital markets in the eastern regions of Indonesia and operated independently prior to the merger in 2007.

As of 2010, there are at least 425 active companies listed on the IDX. More than Rp92.5 trillion (equal to US\$10.3 billion<sup>5</sup>) has been raised during the initial public offerings with total market capitalisation about Rp3,243.8 trillion (US\$360.4 billion). This means that the average composite index has been increasing over 3,000 basis points. The IDX has been reported, as of the 2010 closing date when the index was at 3,703.51, as the Asia-Pacific region's best-performance stock market ('IDX closes 2010 atop Asia Pacific' 2010).

As one of the Self-Regulatory Organisations (SROs), the IDX is empowered to issue regulations governing its activities with BAPEPAM-LK approval<sup>6</sup>. Like other exchanges, the IDX specifies rules regarding its members' and listed companies' rights and obligations. Tabalujan's study (2002) classifies the exchange's rules into a decree of IDX's board of directors and a circular letter. A director of surveillance and compliance is responsible to ensure the exchange members and listed companies comply with BAPEPAM-LK and IDX requirements.

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<sup>4</sup> BAPEPAM's role was changed to the Indonesian Capital Market Supervisory Agency (or *Badan Pengawas Pasar Modal* also known as BAPEPAM). Later, based on Ministry of Finance Decree No 606/KMK.01/2005 as of 30th December 2005 concerning organisation restructuring, it had combined an Indonesian Securities Exchange Commission and a General Directorate of Financial Institutions as a Capital Market and Financial Institutions Supervisory Agency (*Badan Pengawas Pasar Modal dan Lembaga Keuangan* or BAPEPAM-LK). It was needed to provide an integrated supervisory authority to reduce risk, particularly within financial services including stock market, banking, pension plan, insurance and other financial institutions.

<sup>5</sup> The exchange rate of US\$1 was about Rp9,000.

<sup>6</sup> Articles 9 and 11 of the Capital Market Law 1995.

### **3.3 Legal foundation of corporate governance**

The nature of Indonesian corporate governance is not separated from the experience of the Dutch legislation system. The existence of a two-tier board system is a characteristic of company structures in civil law countries. The history of corporate governance dates back to the establishment of *the Dutch Verenigde Oostindische Compagnie* (VOC) in 1602. The VOC main settlement for the Far East was in Batavia, modern Jakarta. As the first huge trading company, the establishment of a supervisory board in 1632 (known as the Committee of Nine) could be described as a milestone due to being the first two-tier board in the world (Kamal 2008). Then, French and Germany introduced their two-tier board structures in the beginning of the nineteenth century.

Much earlier colonial legislation has continued to affect Indonesia since independence in 1945, when Indonesia based its domestic legislation on local precepts of law and justice. Indonesia's main laws related to corporate governance are the Company Law 2007, Capital Market Law 1995 and Investment Law 2007. The Indonesian government through BAPEPAM-LK is presently seeking amendments to the Capital Market Law 1995 to give it greater power to combat fraud, such as authority of cross-border investigations (Robinson 2009). Following are brief explanations of these laws.

#### **3.3.1 Indonesian Company Law 2007**

In Indonesia, practising good corporate governance is related to legal obligations of company establishment. There are several legal foundations surrounding Indonesian corporate governance. Company Law 40/2007 enacted on 16 August 2007 (amendment of 1995 Company Law) is considered the centre of Indonesia's formal legal framework<sup>7</sup> for corporate governance (Achmad 2007). This amendment is the second revision of the Company Law since the earlier colonial Commercial Law of 1847 (Tabalujan 2002). The amendment is needed to establish business in line with good corporate governance practices.

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<sup>7</sup> The hierarchy of Indonesian legislation is based on the People's Consultative Assembly Decree, as follows: the 1945 Indonesian Constitution; decree of the People's Consultative Assembly; law or act; government regulation in lieu of a law; government regulation; presidential decrees; presidential instruction; ministerial decree; ministerial instruction; and several of regional regulations.



**Table 3.2 Corruption in Asia-Pacific**

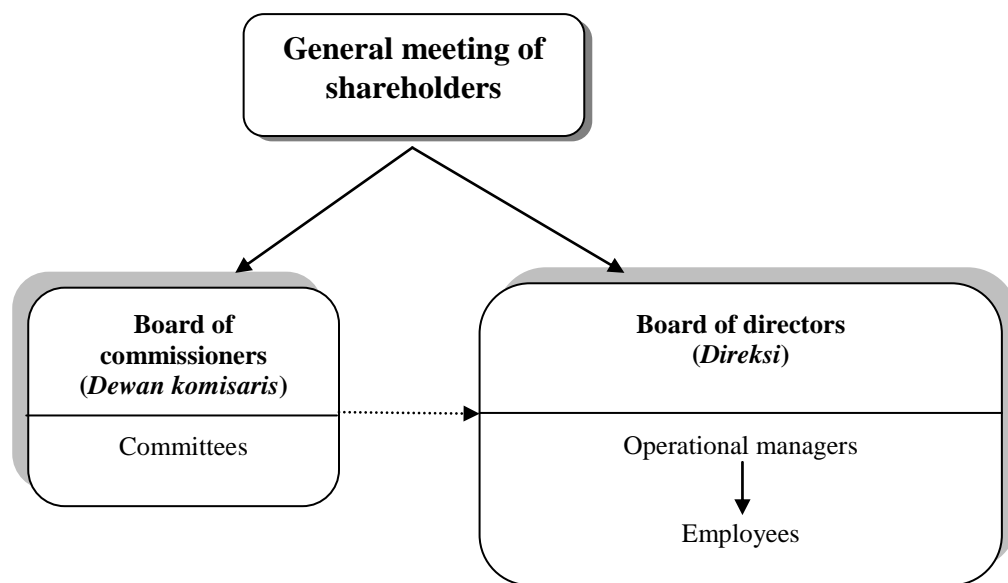
<b>2010 Rank</b>	<b>Score</b>	<b>Country</b>	<b>2009 Rank</b>
1	1.42	Singapore	1
2	2.28	Australia	3
3	2.67	Hong Kong	2
4	3.42	US	4
5	3.49	Japan	5
6	4.96	Macau	7
7	5.98	South Korea	6
8	6.28	Taiwan	9
9	6.47	Malaysia	10
10	6.52	China	8
11	7.18	India	13
12	7.60	Thailand	15
13	8.06	Philippines	11
14	8.07	Vietnam	12
15	9.10	Cambodia	14
16	9.27	Indonesia	16

Source: PERC (2010)

Government concern with the implementation of good corporate governance is reasonable. An international survey conducted by the Political and Economic Risk Consultancy (PERC) in 2010 has ranked Indonesia as the most corrupt nation. Indonesia scored 9.27 out of 10 points as the riskiest among the 16 Asia-Pacific key investment destination nations. The analysis polled 2,174 middle and senior business executives in Australia, the US and Asia. This position is just below Cambodia as the second most corrupt, followed by Vietnam, the Philippines, Thailand, India, China, Malaysia, Taiwan, South Korea, Macao, Japan, the United States, Hong Kong, Australia and Singapore (Wong-Anan 2010). The poor situation of Indonesia reflects that corporate governance has not yet been taken into account in transformation of Indonesian business and company operation.

With regard to the new Company Law 2007, Indonesian companies are required to establish two-tier board systems. This consists of a board of directors (BOD, called a *Direksi*) and a board of commissioners (BOC, known as *Dewan komisaris*). This board of directors is headed by a president director, and the board of commissioners is chaired by a president commissioner. The board of directors shall undertake the management of

companies by running daily operational activities; the board of commissioners shall supervise management policies and give advice to this BOD. Both board of directors and board of commissioners are appointed and responsible for the general meeting of shareholders. A graphical display of these three company structures is set out in Figure 3.1.



**Figure 3.1 Three company structures**

Source: Company Law 40 of 2007

**a) General meeting of shareholders (GMS)**

According to Company Law 2007, GMS are the highest authority of a company. Chapter VI of the Law mentions that the GMS has any authority not given to the board of directors and board of commissioners within the limit specified in acts and/or the company's articles of association. This structure has authority to decide things related to the organisational structure of the company (such as establishing and changing the company's by-law, spinning-off, merging and even liquidating the company). In order to maintain a company as a going concern, the ultimate role of the GMS is that of appointing and dismissing both board of directors and board of commissioners.

There are annual and extraordinary GMS to discharge the role of the company structures. The annual GMS has to be held within six (6) months after a fiscal year is over and, as urgent call for a meeting, an extraordinary GMS can be held at any time as needed for the improvement of the corporation. The board of directors and the boards of commissioners are supposed to convene a general meeting; however, if they fail to make a summons of a GMS within a particular time limit, shareholders requesting a GMS may send a request to the court ordering it to make a summons of a GMS. This authority is given to discharge the ultimate general meeting of shareholders' role.

**b) The board of directors (*Direksi*)**

Within this context, the board of directors is a management board. Article 1 paragraph (5) indicates that the board is the company structure with full authority and responsibility for the company management in accordance with the company's purposes and objectives. The board also represents the company in and out of court in accordance with the provision of the articles of association. This means that the board is the executive management of the company that is responsible for the company's daily activities. Members of the board are fully personal liable if they are committing a wrongdoing or are negligent in discharging a role and duty.

In general, limited liability is required by at least one member of the board. However, financial sector companies and public companies are obliged to assign at least two members of the board. The division of management tasks between members of the board shall be determined by GMS or board resolution. The provision of other requirement could be according to authorised technical agencies pursuant to legislative regulations. Moreover, to be eligible as a director, someone is required to be capable of performing legal actions, except those who in the 5 (five) years previous to their appointment have been: (a) declared bankrupt; (b) members of directors or commissioners declared as causing company default or bankruptcy; and (c) sentenced for crimes.

**c) The board of commissioners (*Dewan komisaris*)**

According to article 1 paragraph (6) of the new Company Law 2007, a board of commissioners is the company structure with tasks of general/specific supervision in accordance with the company's articles of association and giving advice to the board of directors. This board of commissioners must have limited liability by at least one member. For the company that has more than two member commissioners (known as a collective board), no member is allowed to act separately. The same provision applies to number of directors: a financial sector company and public company must appoint at least two members of commissioners. This requirement is intended to protect the public interest from wrongdoing and the influence of insider parties.

According to chapter IV of this law, commissioners' roles are related to work plans, annual reports and the use of earnings. Apart from the right to receive an upcoming year work plan from the *Direksi*, the board of commissioners has to review this plan before GMS approval. Approval could be done by a board of commissioner in the event that the articles of association specify this authority. The board of commissioners is also required for reviewing and signing company annual reports. Additionally, the board of commissioners is responsible for approving the proposal of interim dividends prepared by the *Direksi*. The other financial role is that the board of commissioners can decide the level of the *Direksi*'s remuneration as stated by the articles of association.

In case the board of directors cannot convene a GMS then the board of commissioners should issue an invitation of GMS pursuant to a court order of the chief judge of the district court. The board of commissioners is also eligible to represent the company in a court where there is a board of directors' conflict of interest. In other situations, the board of commissioners also may give written approval and assistance to the board of directors to do a particular legal action.

According to article 106 paragraph (1) a board of commissioners has the right to 'suspend' the board of directors (*Direksi*) by providing a specific reason. This is an ***important issue*** since an amendment of this law has been made. However, a permanent dismissal is absolutely the GMS's task. After suspending a *Direksi*, a board of

commissioners could take over management's role to organise the company during a specific time frame.

Concerning a merger and acquisition, the board of commissioners facilitates the approval draft of the merger and takeover of the company. Articles 123 paragraphs (3) say that before a draft is submitted to the GMS of each company, it is required to obtain approval from each member of the board of commissioners. This procedure is the same where an acquisition is also taking place.

### **3.3.2 Capital Market Law 1995**

A second important regulatory framework concerning corporate governance is the Capital Market Law 1995. The law was promulgated on 10 November 1995 and came into force on 1 January 1996. As mentioned earlier, the Company Law is applied to all limited companies in Indonesian legislation, while the Capital Market Law regulates public companies only. Listed companies consist of at least 300 shareholders who have paid in capital at least Rp3 billion (about US\$333,000.00).

In general, the Capital Market Law facilitates the BAPEPAM-LK and other capital market participants in discharging their roles in the Indonesian capital market. The law provides a sound legal foundation and enumerates the BAPEPAM-LK authority in matters of furthering regulation, development, supervision and enforcement. It also clarifies the authority and responsibility of SROs (Indonesian Stock Exchange, *Kustodian Sentral Efek Indonesia* (KSEI) – the securities depository institution, and *Kliring Penjaminan Efek Indonesia* (KPEI) – a clearing and guarantee body), securities companies, professionals, issuers and investors in doing business in the capital market.

Furthermore, this law determines several key aspects of corporate governance, particularly transparency and fairness in stock market activities. Issuers are required to submit periodical reports to BAPEPAM-LK and to announce publicly their reports<sup>8</sup>. BAPEPAM-LK also requires issuers to prepare financial statements based on generally

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<sup>8</sup> Article 86 of the Capital Market Law 1995

accepted accounting principles and other permitted accounting treatments<sup>9</sup>. Then, those involved in violating rule and regulations, such as misleading information, market manipulation and insider trading, will have sanctions imposed in the form of administrative sanctions or be referred to prosecutors<sup>10</sup>.

To ensure a company is managed independently, this law makes provision that a company's structure must not be influenced by a conflict of interest. It is aimed to ensure the carrying out of objective decision-making. Directors' and commissioners' ownership and those holding more than 5 (five) percent of shares shall be reported to BAPEPAM-LK. Among other things, even though the law was enacted before the guidance of Indonesia's code of corporate governance, this law and its government regulation supplements put strong conditions on practising corporate governance.

### **3.3.3 Investments Law 2007**

The latest piece of legislation which requires implementation of corporate governance in Indonesia is the Investments Law 25/2007. The legislation was enacted on 26 April 2007. The Legislative Assembly approved this law with the sole intention of making Indonesian territory more attractive to foreign investment. Under this legislation, there are no separation procedures dealing with domestic and foreign investment, and it covers capital investment in all business sectors.

There are some new features of the amended investment law. The amended investment law provides equal treatment between domestic and foreign investment, although different entry requirements remain in place by applying foreign participation percentages in the negative list. According to article 18 paragraphs (40), the other most prominent feature is the tax incentives granted to business ventures. Tax incentives have been given to new investment in the form of: income tax reduction; duty-free on imported production facilities; duty-free on imported raw material in a particular period; value-added tax on imported production facilities; accelerated depreciation and amortisation and property tax reduction.

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<sup>9</sup> Articles 69 of the Capital Market Law 1995

<sup>10</sup> Chapter 11, 14 and 15 of the Capital Market Law 1995

The law also applies in particular situations. Legislation also ensures granting of tax incentives to company ventures in rural and border areas. It is aimed at absorbing large-scale manpower into the workforce. In broader terms, it is allowable to use foreign professionals if such skills are not found among local employees. Government also guarantees not to enforce nationalisation of company assets. Land acquisition with leases also has become permissible for an initial 60 years with the option to extend for another 35 years. Lease of buildings will be permitted for an initial 50 years with an extended option for another 30 years.

The law also introduces investor obligations and responsibilities. Among other things, by way of obligation, article 15 item (a) requires *investors to practise good corporate governance*, to perform company social responsibility and to respect local tradition and culture. If the investors are unsuccessful in fulfilling these obligations, then they may have their company closed. Closure of venture is usually after a sequence of warnings. In the same way, among other things, it is now the investor's responsibility to provide sufficient capital to establish a new venture or expansion of an ongoing business and to settle all obligations and losses if they discontinue, leave and abandon the business.

### **3.4 Corporate governance implementation in Indonesia**

There are numerous studies exploring corporate governance practices at both macro and micro levels in Indonesia. However, a recent survey by the Political and Economic Risk Consultancy (PERC) in 2010 ranks Indonesia as the most corrupt of 16 major Asia-Pacific investment destinations. The survey shows that corruption in Indonesia has become a "serious" problem (Wong-Anan 2010). This situation was noted by the World Bank (WB) Country Director a decade ago with poor governance being regarded as a major factor in causing the financial crisis in Indonesia, contributing to its severity and length (Baird 2000).

Turning to the micro level, Lukviarman (2004) has found that companies are characterised as having: (1) concentrated ownership by individuals or groups; (2) pyramidal ownership structures in a small number of families; (3) family member

dominance in boards or executive teams; (4) ineffective oversight roles due to close relationships between shareholders (owners) and the board of commissioners; (5) weak market control since only a relatively small percentage of company shares are being sold in the capital market; (6) relatively high leverage ratios; and (7) many companies under the same ownership. These findings are consistent with the finding of Zhuang et al. (2000) in the context of China. The WB again underlines that corporate governance has been seen primarily as a compliance issue rather than a means of enhancing corporate performance (Baird 2000).

For these reasons, Indonesia established the National Committee for Corporate Governance (NCCG) in 1999. The main duty of the NCCG is to strengthen, disseminate and promote good corporate governance principles. Its mission is to instigate and enhance the effectiveness of the application of good governance in order to establish a culture in which good governance principles are internalised, in public as well as corporate sectors.

Trusting that corporate governance is important for promoting country economic development, there were at least three significant steps covering national policy, regulatory framework and private initiatives (Daniri 2000). First, the Indonesian government has established the NCCG since 1999 under Decree of Coordinating Minister for Economic Affairs. The first Code for Good Corporate Governance was published by the NCCG in 1999, an institution prior to the NCG establishment in 2004<sup>11</sup>. After issuing this Code, the NCG also published guidelines for independent commissioners and audit committees in 2004.

In relation to the implementing of good corporate governance principles, the Indonesian government has amended some of its key regulations to form a strong foundation for corporate governance (Achmad 2007). Daniri (2000) also states that the BAPEPAM-LK

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<sup>11</sup> Since 2004, the scope of the committee has included not only corporate sectors, but also public sectors. Therefore, Decree Kep-49/M.EKON/11/TAHUN 2004 of the Coordinating Minister for Economic Affairs has changed the committee's name from the National Committee for Corporate Governance (NCCG), established in 1999, to the National Committee on Governance (NCG). Recently, the Ministry has reconfirmed the governance implementation and the NCG duties with Decree Kep-14/M.EKON/03/TAHUN 2008.



and SROs (i.e. IDX), supported by the WB and ADB, have conducted some corporate governance projects including BAPEPAM-LK's 2003 shortening of its submission dates for financial statements from 120 to 90 days after the ending of the fiscal year. This regulation implements fairness in corporate governance. Since 2001, IDX has required that all listed firms comply with corporate governance principles.

Moreover, some private sectors<sup>12</sup> have also initiated taking responsibility to disseminate corporate governance in Indonesia. This is the Forum of Corporate Governance in Indonesia (FCGI) established in 2000 by five professional and business associations<sup>13</sup>. FCGI's aim is to enhance awareness and to disseminate good corporate governance principles to Indonesian business communities based on international best practices. There are other private initiatives such as the Indonesian Institute for Corporate Directorship (IICD), the Indonesian Directors and Commissioners Initiative, the Indonesian Institute of Independent Commissioners, the Commerce Chambers (KADIN) Corporate Governance Task Force, and the Indonesian Institute of Corporate Governance (Wibowo 2008).

Since 1999, Indonesia has improved its model of corporate governance. The NCG has implemented the 2006 Code of Good Corporate Governance as the revision of the 2001 version. The important feature in the new Code is motivated by a need to ensure the availability of a framework as a basis for effective corporate governance (OECD 2004). The NCG also published guidelines for independent commissioners and audit committees in 2004. The following describes the GCG Code and the guidelines.

### **3.4.1 Indonesian Code of Corporate Governance 2006**

The Code of Good Corporate Governance 2006, hereafter called the GCG Code, is regarded as a living instrument offering standards and also guidance for companies. The

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<sup>12</sup> Their initiatives can be accessed at the following websites: [www.fcgi.or.id](http://www.fcgi.or.id); [www.iicd.or.id](http://www.iicd.or.id); [www.komiteaudit.org](http://www.komiteaudit.org) and [www.iicg.org](http://www.iicg.org).

<sup>13</sup> It consists of *Asosiasi Emiten Indonesia* (AEI) – the Association of Indonesian Listed Companies, *Ikatan Akuntan Indonesia – Kompartmen Akuntan Management* (IAI-KAM) – the Management Accountant Compartment – Indonesian Institute of Accountants, the Indonesian Financial Executives Association (IFEA), the Indonesian Netherlands Association (INA) and *Masyarakat Transparansi Indonesia* (MTI) – the Indonesian Society for Transparency.

GCG Code is not a formal legislation in Indonesia; however, it is an essential guidance for companies to implement their efforts at assuring long-term business continuity within appropriate business ethics. It is stated in its preamble that the purposes of the GCG Code are:

1. to achieve sustainable growth of the company through a management system based on the principles of transparency, accountability, responsibility, independency and fairness
2. to empower the function and independency of each company structure, specifically, boards of commissioners, boards of directors and GMS
3. to encourage shareholders, members of board of commissioners and board of directors to take decisions and actions based on high moral values and compliance with the law and regulations
4. to stimulate company awareness of social responsibilities, in particular the environmental and societal interests of the communities where a company operates;
5. to optimise the value of the company for its shareholders by also taking into account the interest of other stakeholders; and
6. to enhance the competitiveness of a company, both domestically and internationally, in order to improve market confidence that perhaps promotes investment flow and a sustainable national economic growth.

The GCG Code contains 8 parts (that revised 13 parts of the 2001 version), namely:

1. Ensuring the basis for an effective corporate governance framework in Indonesia.  
Implementation of good corporate governance needs to be supported by three inter-related pillars, namely: (a) the regulatory; supervisory and enforcement authorities as policymakers; (b) the business community as market participants and (c) the public as end-users of product and services of the business community. Under this part, the GCG Code provides provisions to ensure each role of these three pillars. Among other important things, the role of the regulatory, supervisory and enforcement authorities is to carry out effective coordination among government agencies in formulating rules and regulations based on the national legal system, by prioritising a policy that is commensurate with the interests of both private and public sectors. Protecting whistleblowers, preventing corruption and issuing laws

and regulations in support of good corporate governance implementation are other roles.

This GCG Code also states provisions for market participants. They are required to implement consistent business ethics and to have attitudes and behaviour in accordance with laws and regulations. Additionally, businesses communities are required to prevent corruption and other demerit conduct (i.e. collusion and nepotism) to continuously enhance the quality of management structures and work patterns of a company based on the GCG Code principles. The other important role is to utilise the ombudsman role to incorporate complaints and/or information about deviations occurring within a company.

The public is also important in ensuring social control, giving due consideration to public services delivered by government agencies and outputs of business communities by conveying objective and responsible opinions. They are also expected to communicate to the government and the business community with regard to opinions and/or objections. Then, the public is required to comply with laws and regulations in a conscious and responsible behaviour.

## 2. The good corporate governance general principles.

Companies are required to ensure that the principles are well implemented on each business facet and across a company. The good corporate governance principles are transparency, accountability, responsibility, independency and fairness (known as TARIF), which are needed to achieve a company's going concern by considering the best interests of stakeholders. First, to preserve and maintain objectivity in practising business, a company shall provide material and relevant information that is without difficulty accessible and comprehensible to shareholders. A company must initiate the disclosure not only of compulsory disclosure information, but also other information deemed necessary by shareholders, investors and other stakeholders to make a decision. Second, a company must be accountable for its performance transparently and fairly. This principle requires a company to be managed in a proper and measurable manner aligned with the interests of management, shareholders and also other stakeholders. Accountability is a must to ensure the company's sustainable performance. Third, the company shall abide by

laws and regulations and fulfil its obligations to the communities and environment. This provision guides structures of a company to ensure prudence in decision-making and in its actions to comply with laws and regulations. Corporate social responsibility is another issue that must be fulfilled by the company. Fourth, there must no single company structure that dominates the others and the company must be managed independently with an appropriate balance of power. It is required that company should be free from outside intervention. Lastly, a corporation must always consider the interests of stockholders and other stakeholders in a fair manner. A channel needs to be established for stakeholders to give input and opinions in the interest of a company. Among other things, a corporation must adhere to equal opportunity in the recruitment of people, in their career development and so that they can discharge their roles professionally.

### 3. Business ethics and code of conduct

Good corporate governance implementation needs to incorporate high integrity in order to attain the company's success in the long-term. Company values, business ethics and codes of conduct must be employed by the company as a reference for the company's structures and employees. Company values constitute a moral basis for achieving the firm's vision and missions. Concerning ethics, this serves as a reference for the company in doing business including interacting with the company stakeholders. Then, company values and business ethics must be elaborated in the company's code of conducts as specific guidance for company structures and employees in conducting daily business activities. Among other things, the GCG Code (NCG 2006) provision also states clearly that:

Each member of the board of commissioners, the board of directors and employees of a company are prohibited from giving or offering something, either directly or indirectly, to an official of the regulatory, supervisory and enforcement authorities and or an individual representing a resource provider, which may influence his/her decision making.

This definition also prohibits them from giving or offering something in their own personal interests. Additionally, donation to a political party or a member of the

legislative or executive body may be done only in accordance with laws and regulations<sup>14</sup>.

#### 4. The company structures

Three company structures have an important role in implementing effective corporate governance. They shall each carry out their function in accordance with an appropriate provision, based on the principle that each structure must be independent in discharging its duty, function and responsibility in the sole interest of the company.

First, as an ultimate structure of the company, the GMS must make a decision properly and transparently by considering things necessary to safeguard the long term interest of a firm. Second, it shall be held in accordance with the interest of the firm and by observing the articles of association and other laws and regulations, and with a proper preparation, to enable the agreement of a valid decision. Last, preparation and conducting GMS is the responsibility of the board of directors. In case those directors are unable to conduct GMS, then the board of commissioners should take the responsibility to convene this event in accordance with the company's articles of association and laws and regulations.

Within two-tier board systems, both the board of commissioners and the board of directors (*Direksi*) have an authority and responsibility based on their respective functions as mandated by their fiduciary roles. For that reason, the board of commissioners and the board of directors must have the same opinion concerning the company's strategic plan. Then mutual responsibilities shall be reflected in: (a) an effective and efficient implementation of a firm's internal control and risk management; (b) an optimum return for shareholders; (c) a proper protection of

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<sup>14</sup> Law 2/2008 Concerning Political Party. Among other things, article 34 mentions that donation can be made to a political party as its fundraising from:  
a. individual member of political party according to its articles of association  
b. individual non-member of political party at annually maximum amount of Rp1 billion;  
and  
c. company and or business establishment at annually maximum amount of Rp4 billion.  
Moreover, article 13 (h) states that political parties are obligated to do bookkeeping, to maintain a list of donors and their donations, and to disclose this to the community.

shareholders' interest; and (d) a fair and proper succession to ensure management sustainability across the organisation.

Moreover, there are several aspects of a board of commissioners. Each commissioner, including the chairman, has the same position. The chairman is *primus inter pares* (first among equals) to coordinate other members' activities. An effective board of commissioners can be observed by looking its composition, integrity and capability, and roles in overseeing and advising the company. In carrying out its duties, a board of commissioners may establish committees. In the case of listed companies, state-owned enterprises, province or regional-owned companies, companies that raise and manage public funds, companies whose products and service are widely used by the public and companies with extensive influence on the environment, the establishment of an audit committee is a must, while other committees (for instance, nomination and remuneration committee, risk policy committee and corporate governance committee) are formed as needed. Overall, the accountability report of the board of commissioners has to be made as part of the company's annual report in accordance with the good corporate governance principles implementation.

Turning to the board of directors (*Direksi*), which is a management boards, the structure shall function and be responsible collegially for daily management of the company. The position of each member and the president director (or the CEO) is equal. Each director can carry out their duty and take decisions based on their assignment and authorities, but the execution of tasks by its individual members remains a joint responsibility. The effectiveness of the *direksi* may be observed by: (1) a sufficient size that suits the business complexity; (2) their professional and integrity to ensure the proper execution of managerial functions; and (3) their roles and responsibility for achieving profitability and ensuring company's going concern in particular areas such as managerial, risk management, internal control, communications and social responsibility. During the directorship period, the board of directors shall prepare a report on their managerial accountability, including a report on the company's activities, financial statements and also the implementation of good corporate governance.

## 5. The rights and role of shareholders

Shareholders have certain rights and responsibilities within the company based on the laws, regulations and the company's articles of association. Their essential rights include: (1) one share and one vote principle; (2) obtaining information concerning the company on a proper, timely and regular basis; (3) receiving profit sharing in proportion to the number of shares owned; (4) obtaining full clarification and accurate information with regard to the convening of GMS; and (5) obtaining a proper right in case there are different classifications of the shares owned. The GCG Code (NCG 2006) also summarises shareholders' responsibilities including: (1) a provision that the controller shareholders shall; (i) keep in mind the interest of minority shareholders and other indicated stakeholders in accordance with proper regulations; and (ii) disclose all information concerning a company's ultimate shareholders to law enforcement agencies, in case of a violation against laws and regulation and an investigation being needed; (2) minority shareholders are required to exercise their rights properly in accordance with laws and regulations; (3) a requirement to separate the company's assets from shareholders' personal assets and also to segregate their position as a shareholder from those appointed as commissioners or directors; and (4) in case of a shareholder being a controlling shareholder in several corporations, it is important to carry out accountability and inter-company relations.

## 6. The rights and role of other stakeholders

Stakeholders are defined as those having an interest in a corporation and directly influenced by operational and strategic decisions of a corporation, particularly including business partners, employees and the surrounding community in which a company operates. There are several principles for creating a sound relationship between a company and its stakeholders: (1) there is no discrimination practices and company development is based on merit; (2) business partner shall cooperate based on a mutual benefit principle; and (3) public interest of both surrounding communities and company's product and service end-users is always considered in strategic and operational decisions.

## 7. Implementation statement of the GCG Code

Each company shall make a separate statement about company good corporate governance implementation. The aim of this statement is to enable the shareholders and other stakeholders to determine the extent of the application of the GCG Code within the corporation. In case the GCG Code is not fully implemented, an explanation is needed to disclose the reasons for non-conformance. The GCG Code, at least, requires companies to disclose: (1) the structure and work mechanism of the board of commissioners and its committees; (2) structure and work mechanism of the board of directors (*Direksi*); and (3) other significant information regarding the implementation of good corporate governance such as: company strategic statements, controlling shareholders, policy of boards' remuneration, transaction with parties having a conflict of interest, outcome of evaluation of good corporate governance implementation, and extraordinary items that might have an effect on the company performances.

#### 8. General guidance on good corporate governance implementation

A systematic approach and continuous manner are needed to implement good corporate governance. Consequently, it is necessary for companies to have their own practical guidance as a reference for company structures and employees to put into practice. A company's governance manual shall include at least the following: (1) the company's vision, mission and values; (2) the position and function of GMS, BOC, BOD, the committee supporting BOC and the internal control system; (3) company policy to guarantee the effective functioning of each company structure; (4) policy to ensure effective accountability, effective internal control and proper financial reporting; (5) internalisation of business ethics and values in a code of conduct; (6) instrument for disclosure of information for shareholders and other stakeholders; and (7) policy on improvement of various company procedures for implementation. Accordingly, effective implementation is required for the participation of all company parties alongside the process. Then, the effort within the company, from disseminating the governance issues to conducting self-assessment, is required to ensure the implementation.



### **3.4.2 Guideline on independent commissioners and audit committees**

Since the two-tier board structure has been adopted, there is the important issue of encouraging the effective board of commissioners and their committees to enable a vigilant oversight and supervising role. The following describes the detailed guidelines on independent or ‘outside’ commissioners and audit committees.

There is an important point from the amendment of the Company Law 2007 that the board of commissioners has a right to suspend a board of directors by providing specific reasons. After suspending them, the board of commissioners could take over daily managerial roles during a specific time frame. The law tries to put the board of commissioners in “a strong position over the board of directors”<sup>15</sup>.

Generally, there is an ordinary and an independent commissioner. An ordinary commissioner is usually appointed from a related party within the company. In order to empower the oversight role of the board of commissioners, the presence of an independent commissioner is becoming important.

Based on a practical standpoint, a member of a board of commissioners is obviously representative of shareholders due to their election, and dismissal can only be undertaken by the GMS. Again, the existence of independent commissioners is needed, in particular, to protect minority shareholders and other stakeholders from conflicts of interest in board decision-making. In the case of publicly listed companies or companies with the nature of business-related mobilisation of public funds, the existence of independent commissioners is required to put into place a cross check mechanism among controlling shareholders (FCGI 2001).

The Jakarta Stock Exchange or JSX (recently known as IDX) passed the directors’ decree Kep-315/BEJ/06-2000, amended by Kep-339/BEJ/07-2001 and then revised by

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<sup>15</sup> However, there are novel thoughts in the Company Law 2007, which contains ideas that do not exist in other two-tier board systems. One of them is that the Indonesian board of commissioners only have the right to suspend the board of directors (Kamal 2008), whereas most strategic roles of commissioners in particular countries such as the Netherlands and Germany include the right to appoint and remove members of boards of directors (DuPlessis, James & Mirko 2005).

Kep-305/BEJ/07-2004, to regulate independent commissioners. According to this decree, independent commissioners are defined as those who: 1) have no affiliation with controlling shareholders of the company; 2) have no affiliation with the board of directors and/or the board of commissioners of the company; 3) at the same time do not work as directors of other companies which have affiliation with the company; and 4) have a sufficient understanding concerning capital market laws and regulations. A detailed code for independent commissioners (*Pedoman tentang Komisaris Independen*) was published by a task force established by the NCG in 2004.

Turning to audit committees, a code for the establishment of effective audit committees (*Pedoman Pembentukan Komite Audit yang Efektif*) was enacted by the audit committee task force of the NCG in 2002. The initial initiative for the establishment of audit committee has been done by BAPEPAM-LK since 2000, by recommending listed companies to have committees, having tasks to assist a board of commissioners, by giving them professional opinions that are independent, in order to raise the quality of management's work, and to reduce the deviation of the management of the company. Moreover, this was becoming compulsory for listed companies according to JSX directors' decree in 2001. They are obliged to have an audit committee where its compositions shall be at least three people; one of them is an independent commissioner who acts as the chair of audit committee. At least one committee member must have a good understanding in financial reporting.

Audit committee roles and responsibilities shall clearly be stated on the audit committee charter. Its role and responsibility may vary from one to another company, but the main audit committee roles and responsibility are to provide independent opinion for the board of commissioners toward integrity of internal control systems, financial reporting practices, risk management and corporate governance implementation.

### **3.4.3 Code for good corporate governance of Indonesian banks**

Due to banking being as highly regulated sector, the NCG and Central Bank of Indonesia (*Bank Indonesia* or known as BI) announced a special code for banking as a supplement to the Indonesian Code of Good Corporate Governance. The Banking

Code<sup>16</sup> shall be implemented in both general banks and people's credit banks<sup>17</sup>. The Banking Code provisions consist of good corporate governance principles; a governance structure; best practices; roles of a supervisory bank authority; and practical guidance for good corporate governance implementation.

A financial intermediation institution needs public trust and must also demonstrate governance principles. Banks shall be transparent in providing such information for their shareholders and other stakeholders in a timely, adequate, clear and accurate manner. A consistent performance measurement shall be established across the institution in line with corporate values, business goals and the bank's strategies, in meeting the accountability requirement.

In order to be a responsible bank, it shall use prudential banking practices and be environment-friendly. Moreover, to be independent, banks have to avoid unfair domination by any stakeholders and leave off from conflicts of interest. This situation is expected to create fairness in doing business.

Relating to the governance structure, there are some requirements to be addressed. The Code provision requires that controlling shareholders, boards of commissioners, boards of directors and other executives have met fit and proper test requirements. The check and balance mechanism is in the form of the relationship between the board of commissioners and the board of directors, with ultimate goals to encourage bank development and health. Auditor and audit committees are prominent parties to implement the mechanism. Therefore, banks are required to establish an internal auditor task force and to appoint auditors (only those registered by the Central Bank of Indonesia) to provide opinion on financial statements. Since many laws and regulations must be fulfilled, banks have to appoint a 'compliance director' to meet existing rules.

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<sup>16</sup> As a formal legal framework, the Central Bank of Indonesia has enacted regulation No.8/4/PBI/2006 as superseded by regulation No.8/14/PBI/2006 concerning Implementation of Good Corporate Governance for General Banks.

<sup>17</sup> The Banking Law 1998 provides for only two types of banks in Indonesia's modern sector: *Bank Umum* (general banks) and *Bank Perkreditan Rakyat* (People's Credit Bank) – which may practise conventionally or be a 'profit-sharing bank' in accordance with Islamic banking principles.

The Code also highlights the roles of a company secretary and *Dewan Pengawas Syariah* (sharia supervisory board) to perform the investor relation function and to ensure Islamic rules.

Apart from the above discussion, the supervisory bank authority (BI) has a right to ensure banks have adopted and implemented sound corporate governance practices. A bank is also required to internalise a code of conduct to be referred to by employees across the organisation with the ultimate goal of pursuing effective of corporate governance.

### **3.5 Financial reporting systems in Indonesia**

The development of the Indonesian accounting system is as complex as Indonesian history. It has been developing since the initial appearance of Dutch colonists to support their daily business bookkeeping. Subsequently, after Independence Day on 17 August 1945, the system remained in use until adoption of US GAAP in 1973. Pressure on improving accounting standards has forced it away from US GAAP to IFRSs in 1994. An IFRS is being fully implemented by 1st January 2012. The following sections describe the legislative framework of Indonesian accounting systems and the development of Indonesian accounting standards.

#### **3.5.1 Legislative framework of the accounting systems**

It is important to note that Indonesian listed companies are required by the new Company Law 2007 and Capital Market Law 1995 to provide financial statements based on Indonesian accounting standards. Both laws affect prominently Indonesian current accounting practices. In addition to these laws, there are other types of legislation that currently influence accounting and disclosure practices, including: Company Registration Law, Pension Funds Law, Government Regulation, Banking Law, and Central Bank Indonesia Law. These prominent legal frameworks are affecting business entities to implement Indonesian financial accounting standards as mandatory disclosures.

**Table 3.3 Key financial reporting practices laws and regulatory**

<b>Regulations</b>	<b>Details</b>
Company Registration 3/1982	It requires company information to publicly accessible. Under the law, companies must report their constitution details included authorised, issued and paid-in capital to the Government.
Pension Funds Law 11/1992	It requires pension funds to submit their audited financial statements to the Minister of Finance (article 52 (1) (a)).
Banking Law 7/1992	Indonesian Central Bank or 'Bank Indonesia' requires banks to prepare audited financial statements on a periodic basis according Bank Indonesia regulations.
Capital Market Law 8/1995	Related to financial reporting, it regulates mainly the preparation, presentation, and audit of financial statements. The law is supported by other BAPEPAM-LK regulations: generally accepted accounting principles (article 69 (1) and (2)); issuers and public company (Chapter IX); and reporting and information disclosures (Chapter X).
Government Regulation 64/1999	This regulation amends government regulation 24/1998 concerning company annual financial information. The regulation promulgated in 1999 reflected a significant improvement in encouraging company transparency. Previous regulation required listed companies only to file audited financial statement, but the new rule enlarges limited liability company to include: those that are publicly listed; those that are in the nature of business-related mobilisation of public funds; those issue debt instruments; companies total assets with at least Rp25billion; and debtors whose annual financial statement is required by the bank to be audited.
Ministry of Trading Decree 121/MPP/KEP/2/2002 on filing of a company's annual financial statement	This amended several regulations on the same subject, such as GR No. 64/1999 and GR No. 24/1998. Similar to the previous regulations, the decree establishes that the following types of entities are required to submit annual financial statements: publicly listed companies; companies involved in accumulating funds from the public (such as banks and insurance companies); companies issuing debt instruments; companies with assets of Rp25 billion or more; bank debtors whose financial statements are required by the bank to be audited; foreign entities engaged in business in Indonesia in accordance with the prevailing regulations and authorised to enter into agreements; and SOEs in the forms of <i>Persero</i> , <i>Perum</i> and <i>Perusahaan Daerah</i> (local government enterprises).
State-Owned Enterprises (SOEs) Law 19/2003	Article 23 (1) requires a SOE's board of directors within 5 months of the end of the financial year to submit its annual report to a shareholders' general meeting (GMS), which is government, for approval. In relation to this financial statement, the GMS or Minister assigns an external auditor to conduct audits for both <i>Persero</i> and <i>Perum</i> (type of SOEs)

	(Article 71 (1)).
Local Government-Owned Enterprise Law 5/1962.	This law states that Local Government-Owned Enterprises are required to submit profit-loss statements, balance sheets and notes on financial statement to shareholders or share <i>prioritet</i> , governors or head of regency. Since scope of this law was not longer relevant to the local government autonomy situation, it is supported by Home Affair Ministry Decree 3/1998 concerning this entity form to be annually audited by public accountants to determine their audited net income as a source of public revenue.
Company Law 40/2007	<p>This law is the most significant law concerning limited liability companies. It replaced law 1/1995 considered no longer in accordance with the legal development and needs of society. This law stipulates financial reporting in Indonesia. The board of directors must submit an annual financial report within 6 months of the end of each fiscal year to the GMS. This law requires a financial statement prepared in accordance with Indonesian accounting standards.</p> <p>This law also requires that the financial statement be audited by public accountants, especially those that are: using public funds (such as banking, insurance, pension plan, finance companies); issuing debt instruments; listing companies; state-owned enterprises in the form of <i>Persero</i>; totalling assets or revenue at least Rp50billion (excepted by government regulation 64/1999); and other limited liability companies are obligated by regulations.</p> <p>This law requires that the annual report must be announced in a newspaper before seven days after being approved by GMS.</p>
'Bank Indonesia' Law 6/2009	This law is establishment of government regulation in lieu of Law 2/2008 concerning 2nd amendment of Law 23/1999. It states that the Central Bank of Indonesia may assign a public accountant, for and on behalf of the Central Bank of Indonesia, to conduct financial audits or special audits.

Source: (ADB 2003) and (Achmad 2007)

### 3.5.2 Indonesian accounting standards

Indonesian accounting standards have evolved significantly since the 1970s. ADB (2003) claims that the standards are now broadly consistent with International Accounting Standards (IAS), recently known as International Financial Reporting Standards (IFRS). The Indonesian Institute of Accountants<sup>18</sup> (*Ikatan Akuntan Indonesia*

<sup>18</sup> The profession was established in 1957 and initially aimed to coordinate and guide Indonesian accountants' activities based on Accountant Title Law (No. 34) 1954.

or IAI) can take credit for this success. Table 3.4 describes the evolution of Indonesian financial accounting standards.

The history of Indonesia accounting standards started in the seventeenth Century when the Dutch introduced the element of double-entry bookkeeping. The fast-growing East Indies Company fulfilled its needs by arriving Dutch and British accountants into the colony (Indonesia). Japan invasion during 1942–45 interrupted Dutch colonial rule and opened opportunities for local accountants. The Dutch accounting system remained in use until the post-independence era of the 1950s (ADB 2003). However, the political decision to nationalise Dutch-owned enterprises and the expulsion of Dutch nationals in 1958 has caused a shortage of technical expertise including accountants.

**Table 3.4 Evolution of Indonesian financial accounting standards**

Until 1973	Early Dutch accounting	Dutch-based legislation and accounting requirements.
1973–1984	PAI – early US GAAP	In 1973, IAI adopts Indonesian Accounting Principles (or PAI), which are directly based on US GAAP (as it existed in Grady’s 1965 work).
1984–1994	Updated PAI	In 1984, PAI are significantly revised to expand their coverage and reflect developments in US GAAP.
1994 to date	International Financial Reporting Standards (IFRS)	At its September 1994 Congress, IAI endorses the use of IFRS (it was IAS) as a basis for domestic financial reporting. IFRS-based Financial Accounting Standards (PSAK) is subsequently issued. Since then, IAI has worked to harmonise PSAK with IFRS and targeted full convergence by 1st January 2012.

Source: ADB (2003)

In response, there was a shift from Dutch accounting to US GAAP. The IAI formally promulgated Indonesian accounting principles (so-called *Prinsip Akuntansi Indonesia* or PAI) in 1973. The first PAI edition was mostly derived from Grady’s work (1965) *Inventory of GAAP for business enterprises*. It was slightly revised in 1984 to incorporate several new Indonesian business concepts (Saudagaran & Diga 2000).

In the early 1990s, ADB (2003) described pressure for accounting improvement since investor confidence was undermined by some financial reporting scandals. For example,

the first and most serious scandal involved Bank Duta, a private bank owned by three Soeharto-controlled charity foundations, then Plaza Indonesia Realty and Barito Pacific Timber. It became clear to government policymakers to improve the quality of financial reporting to transform the Indonesian capital market from a casino into a sophisticated mechanism for mobilising long-term investment flows.

IAI decided to change from US GAAP and mostly adopted International Accounting Standards (IAS) in 1994. PAI was renamed Indonesian Financial Accounting Standards or *Pernyataan Standard Akuntansi Keuangan* (PSAK). Three major reasons drove this decision (ADB 2003). First, US GAAP is inextricably intertwined with US laws and legal precedents – factors not easily exported to another country. Second, US GAAP is rule-based rather than principle-based. Third, US GAAP is fragmented and complex. It includes accounting research bulletins, APB opinions, over 140 FASB statements, scores of interpretations, technical bulletins, statements of position and accounting guides issued by the AICPA. Fourth, IAS is less complex to adopt and has been developed in a consistent manner.

The PSAK are mandatory for all public companies and business entities that are obligated to prepare financial statements. The PSAK is largely based on IAS and represents the joint product of IAI, BAPEPAM-LK, Arthur Andersen and the World Bank, which funded this publication (Rosser 1999). At the same time, the government also runs a joint project with the World Bank to train accounting professionals and further develop accounting regulations. In this case, 1995 was an important point as the baseline period by the promulgation of the Company Law 1995 (superseded by the Company Law 2007) and the Capital Market Law 1995. Several articles on both these laws (see Table 3.1) made PSAK mandatory for all listed companies in preparing their annual reports.

IAS has been adapted to the PSAK since 1994, but global market integration has been taken into account to fully adopt IFRS to improve the Indonesian position among trusted investment destinations. The Indonesian Financial Accounting Standard Boards



(DSAK) in cooperation with BAPEPAM-LK is targeting to fully adopt IFRS by 1st January 2012<sup>19</sup>.

World Bank (2010) criticises Indonesia because of missing the deadline of convergence efforts by 2008. The report details that as of 1 January, 2010, none of the 43 existing PSAK can be viewed as fully comparable with IFRS; 7 PSAK are totally non-comparable with IFRS; 26 PSAK have minor gaps with IFRS; 5 PSAK have moderate gap with IFRS; and 5 PSAK have significant gaps with IFRS. Reflecting these figures, it is become urgent to meet this convergence efforts in order to get optimal international community recognition, and as well as to improve the quality of more transparent financial information of Indonesian listed companies.

### **3.5.3 Financial reporting requirements**

A legislative framework of financial reporting requirements (see Table 3.3) governs Indonesian corporate disclosures. The implementation is regulated by several different government agencies and private sector organisations (ADB 2003; Saudagaran & Diga 2000). Table 3.5 summarizes agencies and organisations concerned with aspects of financial reporting in Indonesia.

Among other things, the statutory power to establish a disclosure requirement belongs to those regularity bodies. However, so far the task of formulating accounting standards (PSAK) is delegated to the Indonesian Institute of Accountants (IAI) through the Financial Accounting Standard Boards (DSAK). Therefore, the PSAK are regarded as generally accepted accounting principles in Indonesia. Other BAPEPAM-LK or IDX rules and circulars are complementary to what is prescribed in the PSAK.

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<sup>19</sup> The Indonesian Financial Accounting Standard Boards (DSAK) is a private sector initiative which produces the only accounting standards (PSAK) endorsed by regulatory bodies for mandatory financial reporting. BAPEPAM-LK has released rule No.554/BL/2010 concerning change of listed company financial reporting guidelines (Regulation VIII.G.7). The regulation mentions that converged PSAK are generally accepted principles for financial reporting. In case any differences exist between the Regulation VIII.G.7 and the PSAK, a listed company shall prepare financial statement in accordance with the PSAK.

**Table 3.5 Regulators concerning Indonesian financial reporting and disclosure**

Agency	Detail of explanation
Bank Indonesia (Central Bank)	Apart from administering Indonesian monetary policies, the Indonesian Central Bank prescribes financial reporting requirements for all banks and non-bank financial institutions operating in Indonesia. Bank Indonesia has promulgated the Guide of Indonesian Bank Accounting or <i>Pedoman Akuntansi Perbankan Indonesia</i> (PAPI) in 2002. The guide was revised in 2008 to incorporate PSAK 50 and PSAK 55 concerning financial instrument: recognition and measurement. The new PAPI is obligated on the Indonesian banking industry on 1 January 2010, instead of PAPI 2002.
Ministry of Finance (MoF)	This ministry oversees the activities of the Directorate-General of Taxation and BAPEPAM-LK.
Directorate General of Taxation	This agency is responsible for administering tax laws. It prescribes the book of accounts and financial statements requirements of all corporate taxpayers.
BAPEPAM-LK	BAPEPAM-LK acts as the overall securities regulator of the corporate securities market in Indonesia. This agency specifies the reporting requirements of domestic companies that intend to raise finance through a public offering.
IDX as Self- Regulatory Organisation (SRO)	The sole privately-operated Indonesia Stock Exchange (IDX) under supervision of BAPEPAM-LK specifies the financial reporting and disclosure for publicly-owned company.
Ministry of SOEs	This ministry is responsible for regulating all aspect of state-owned enterprises. A part from GMS and representatives of government, SOE law requires these entities to comply with the Indonesian GAAP and periodically submit their annual financial statements.
BP MIGAS	Upstream oil and gas companies in Indonesia do not file their financial statements to the MoF. The rationale is that upstream oil and gas companies in Indonesia have submitted their financial statements under the underlying contract (i.e. PSC or other type of contracts) to BP MIGAS on a quarterly basis. As such, the companies believe that they have met their obligation for filing their financial statements to the government.

Source: summary of related regulations

All the above agencies prescribe the PSAK as a main reference for companies to present their financial statements. In addition, the laws authorises those agencies to establish accounting regulation with respect to their authorities when necessary, such as Regulation VIII.G.7 of BAPEPAM-LK for listed companies or PAPI 2010 for banking. World Bank (2005) indicates that the oversight of accounting has been improved, but more effective enforcement is still required.

### **3.5.4 Auditing and professional infrastructure**

Financial reporting is required by government agencies to meet companies' obligations, therefore a verification of accurate and faithful accounting reports of an entity's financial information is required. The following discusses the development of auditing and the auditing profession in Indonesia.

It is recognised that the underlying auditing philosophy is to ensuring that accounting records have been kept and verifying compliance with generally accepted accounting principles (Flint 1988). Audited financial users, including investors, should be able to rely on the audit function to provide a comprehensive review of the information being verified and the estimates behind it (ADB 2003). Accordingly, the quality of information that has been the subject of an independent examination can influence the market value of the company, as the users put a higher level of trust in it.

From 1973 to 1994, the profession used to conduct auditing based on the Accountant Examination Norm (*Norma Pemeriksaan Akuntan*). In the following period, Generally Accepted Accounting Standards (GAAS) are codified as part of the Professional Standards for Public Accountants (*Standard Profesi Akuntan Publik* or SPAPs). The first ever SPAPs were issued together with the revised accounting standards (PSAK) on 1 August 1994. The SPAPs comprise auditing standards, attestation standards, accounting and review standards, consulting services standards, quality control standards and the code of professional conduct (IAI, 2001). These standards consist of a mixture of International Standards of Auditing (ISA) and the U.S generally accepted auditing standards.

The auditing profession was historically established with the forming in 1907 of the State Accountant Bureau with responsibilities including auditing companies' accounts (ADB 2003). These functions were undertaken by accountants from the Netherlands. Following the independence of Indonesia in 1945, the government registered accounting alumni of state universities as State Registered Accountant (SRA) holders. There were more than 40,000 SRA holders in 2004, but they are rarely pursuing a licence for practising accountants. Licensing from the Ministry of Finance (MoF) was based on

experience only until the promulgation of MoF decree No.43/KMK.017/1997<sup>20</sup> concerning the public accountant service.

This MoF decree tightens public accountant licensing by using a uniform CPA examination conducted by the Indonesian Institute of Accountants<sup>21</sup>. Only SRA holders are eligible for the CPA exam. As of August 2010, there are 920 licensed CPAs at 501 accounting firms. This total of CPAs is regarded as a scarce resource to uphold an aggregate audit quality, compared with the total number of CPA in other ASEAN countries (IAPI 2010). For example, Singapore has more than 15,000 CPAs, or Thailand has also more 6,000 CPAs with less population than Indonesia. Therefore, one of the aims of the recent Public Accountant (PA) Law of 2011 is encouraging the quantity and quality of Indonesian public accountants.

### **3.6 Potential problem of accounting irregularities**

#### **3.6.1 Recognising the problems**

Recent accounting irregularities incidences have victimised prominent companies including Enron, Tyco, WorldCom and HealthSouth and shaken investors' confidence. A survey by Beasley et al. (2010) shows that initial publication in the press of an alleged fraudulent financial reporting resulted in an average 16.7 percent abnormal share price decline in just the two days surrounding the announcement. Furthermore, news of referring cases to criminal investigation resulted in an even worse negative market response in an average 7.3 percent of share price. Indeed, some samples saw their share values plummet and experienced credit rating decline of their bonds, some to junk status. More serious accounting irregularities incidences, it will be reflected with more severe negative market reaction. The problem of accounting irregularities can happen everywhere including an emerging market such Indonesia.

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<sup>20</sup> This decree has been superseded by FoM decree No.470/KMK.017/1999 and amended by No.423/KMK/06/2002.

<sup>21</sup> The Indonesian Institute of Accountants (IAI) consists of compartments including IAPI or the Indonesian Institute of Certified Public Accountants (IICPA) and the government recognises the IICPA as the only auditing profession in Indonesia following MoF decree No.17/PMK.01/2008. Since then the CPA examination is solely conducted by IICPA.

**Table 3.6 Total cases related to issuers**

<b>Year</b>	<b>Total cases</b>	<b>Total issuers</b>	<b>Percentage of cases reported</b>
2000	167	287	58.19%
2001	240	316	75.95%
2002	192	331	58.01%
2003	121	333	36.34%
2004	317	331	95.77%
2005	163	336	48.51%
2006	146	344	42.44%
2007	151	383	39.43%
2008	228	396	57.58%
2009	313	398	78.64%
Average			59.08%

Source: BAPEPAM-LK (2000-2009)

In contrast of efforts to attract more investors within Indonesia market, revelations of poor quality of reporting earnings continue to mount. There are significant numbers of sanctioned issuers because of inadequate disclosures, insider transactions and other market manipulations in the recent decade. According to BAPEPAM-LK's annual reports, there have been an average 59.08 percent of issuers sanctioned in violation of laws and regulations. The widespread default of issuers' disclosure has largely been blamed on poor corporate governance mechanisms. Worries about accounting irregularities are widely cited as the reason for the undermining of investors' trust following these scandals. Following is the current BAPEPAM-LK's role in ensuring investor protection.

### **3.6.2 BAPEPAM-LK's role in deterring accounting irregularities**

The main capital market regulator in Indonesia is the Indonesian Capital Market and Financial Institutions Supervisory Agency or *Badan Pengawas Pasar Modal dan Lembaga Keuangan* (BAPEPAM-LK)<sup>22</sup>. It is a division of the Ministry of Finance and a

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<sup>22</sup> Based on Ministry of Finance Decree No 606/KMK.01/2005 as of 30 December 2005 concerning organisation restructuring and it combined the Indonesian Securities Exchange Commission and the General Directorate of Financial Institutions as the Capital Market and Financial Institutions Supervisory Agency (*Badan Pengawas Pasar Modal dan Lembaga Keuangan* or BAPEPAM-LK). It was needed to provide an integrated supervisory authority to reduce risk, particularly within financial services including stock market, banking, pension plan, insurance and other financial institutions. Furthermore, the Indonesian government is

statutory body that is responsible for ensure the capital market operates in an orderly, fair and efficient manner in order to protect the interest of investors and the public. BAPEPAM-LK's functions are similar to those of the US SEC. BAPEPAM-LK is currently seeking amendments to the Capital Market Law 1995 to give it broader powers to deter fraud. The proposed revisions will allow cross-border investigations where violations are committed by overseas brokers and will empower it to commence trials on behalf of public and investors, against market participants acting fraudulently in the Indonesian capital market.

BAPEPAM-LK has authority to conduct a formal investigation (*pemeriksaan*) and a criminal investigation (*penyidikan*) as mentioned in Capital Market Law 1995 article 100 and 101, respectively. BAPEPAM-LK may issue a formal investigation towards a person, a company or an institution that allegedly commits a violation against Capital Market Law and other implementation rules<sup>23</sup>. During the formal investigation, a person or a public company may be asked to do and not to do a certain task, such as refiling a financial statement, by an investigator. When there is proof of acts harming the capital market, investors and the public, then BAPEPAM-LK may conduct a criminal investigation<sup>24</sup>. BAPEPAM-LK's civil investigator (*Penyidik Pegawai Negeri Sipil* or known as *PPNS*)<sup>25</sup> usually precedes the defendant to a prosecutor at a local court after investigation of criminal cases. Cases handled by BAPEPAM-LK are related to issuers and public company disclosures, securities trading and investment management.

Legal certainty is needed in order to improve the level of investor trust in the Indonesian capital market industry. BAPEPAM-LK has authority to impose sanctions (in the form of fines or administrative sanctions) in cases related to public company disclosure. Issuers' disclosure includes violation of transactions related to conflicts of interest, material transactions, particular shareholder disclosures, material facts of information

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anticipating enactment of the Financial Services Authority (*Otoritas Jasa Keuangan* or OJK) by January 2013 as a single independent body for overseeing financial service industries that presently are conducted by BAPEPAM-LK and Directorate of Banking Supervision of BI.

<sup>23</sup> Article 100 point (1) of the Capital Market Law 1995

<sup>24</sup> Article 101 point (1) of the Capital Market Law 1995

<sup>25</sup> Article 101 point (6) mentions that BAPEPAM may ask other law enforcement authorities, such as Indonesian National Police, Directorate General of Immigration, Department of Law and Justice and Attorney-General.

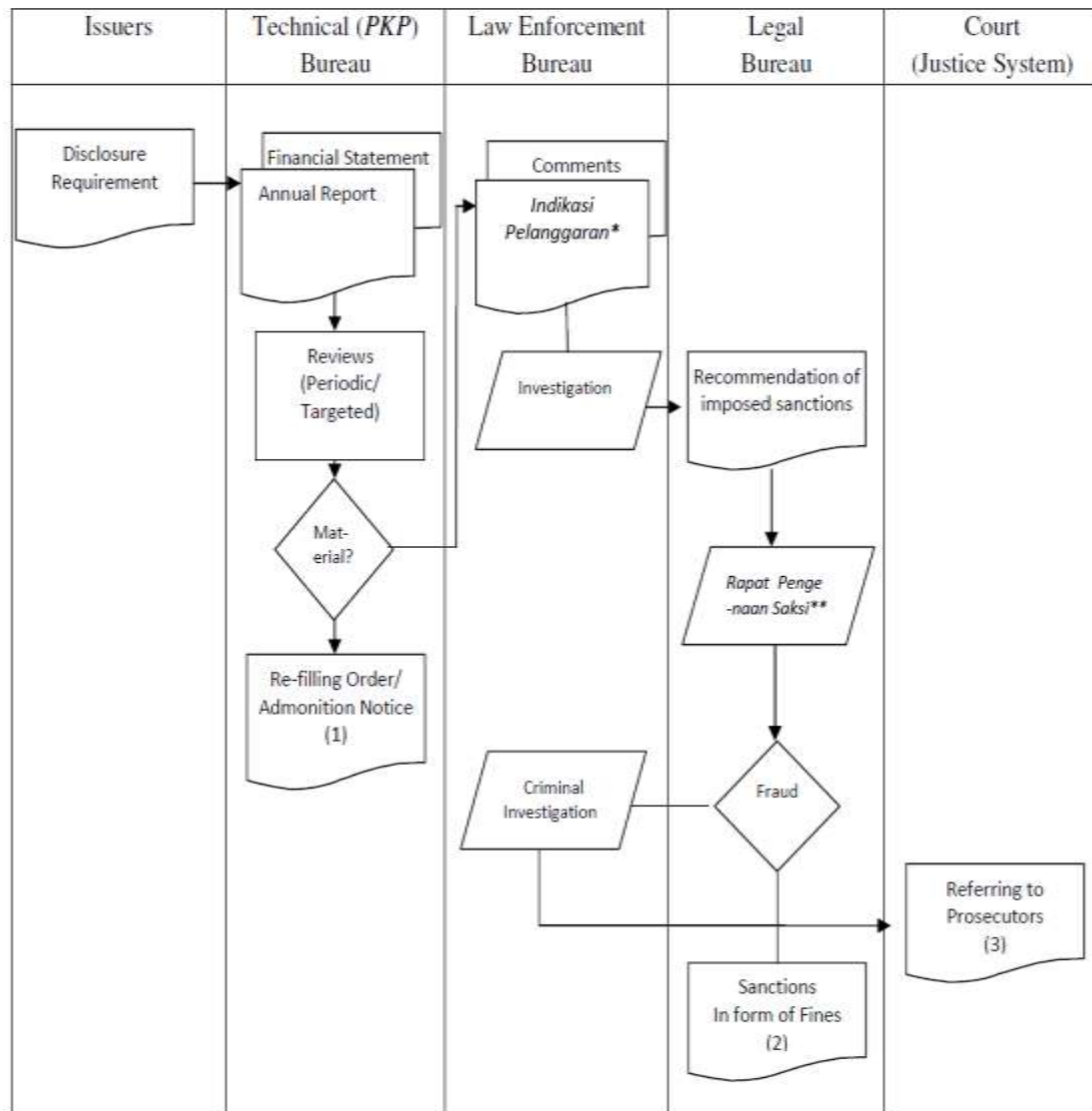
that must be disclosed to public, financial statement presentation and use of funds generated from public offers. BAPEPAM-LK is facilitated by the law to deter these misstatement practices by imposing an appropriate administrative sanction.

BAPEPAM-LK may impose administrative sanctions in the form of fines and non-fines<sup>26</sup>. Under the current law, a fine is imposed according to the seriousness of a harmful act, and the maximum level of fine is Rp15 billion (about US\$1.6 million). Non-fine administrative sanctions vary from written admonition and suspension to revocation of business licence. As mentioned earlier, a very serious capital market offence may be carried to a local court prosecutor to determine an imprisonment term for a perpetrator. In case of accounting irregularities, for instance, issuers who are prosecuted are perhaps categorised as the most severe offence. Fined and warned activities can be the second and third less serious acts against disclosure requirements.

BAPEPAM-LK is responsible for law enforcement within the capital market and some areas of its authority (see Figure 3.2). The level of sanction imposed on the perpetrator is determined by the seriousness of the breach of the laws and related regulations. Investors and the public may access the level of cases' severity by looking at the status of the sanction imposed by BAPEPAM-LK.

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<sup>26</sup> Article 102 of Capital Market Law 1995



**Figure 3.2 BAPEPAM-LK enforcement system of reporting issuers in defaults**

Source: developed from BAPEPAM-LK's annual reports and other sources

In order to track cases' seriousness, this study considers three level of sanctions imposed according to their gravity of the accounting irregularities detected by BAPEPAM-LK. Level (1) is the least serious case and (3) indicates the most severe case against the Indonesian disclosure requirements.

\**Indikasi Pelanggaran*: the indication of offence;

\*\**Rapat Pengenaan Sanksi*: the meeting for sanctions imposition.

### 3.6.3 Accounting irregularities issues in Indonesia

As an emerging economy, the stock market has been seen as one of the important sources of company funding in Indonesia. In the last decade, post the Asian crisis, Indonesia has become more regulated to boost investors' confidence. The overall result confirms the achievement of this goal. In 2010, for example, Indonesian companies



raised more than US\$11.1 billion (Rp100 trillion) on the Indonesian Stock Exchange (IDX) through a massive amount of initial public offering (IPO) and other securities issuance. The net inflow of foreign capital is about US\$2.97 billion (Rp26.74 trillion). The IDX's market capitalisation increased 60.63% from Rp2, 534.36 trillion an 2009 end year to Rp3,247 trillion as of 30 December 2010. The level of activity is a measurement of market participant confidence in the economy.

Considering the above figures, this shows that the market has regained confidence. Therefore, maintaining a robust market is everyone's concern. In Indonesia, BAPEPAM-LK gives a serious attention to cases that undermine the confidence of the capital market. A violation against disclosure regulations and fair securities trading are cases, to name but a few, which cause the market to deteriorate. History has explained valuable lessons, and many times such cases repeated themselves.

Apart from a positive market performance in 2010, there is a potential drawback in the Indonesian economy. As mentioned earlier, PERC has ranked Indonesia as a "serious" problem of corruption. Meaning that errors and irregularities in financial reporting information are on high alert or even unstoppable. If such incidences are not well recognised and deterred, this could undermine investors' trust. For instance, in last recent decade BAPEPAM-LK has fined annually more than 170 listed firms and further investigated more than 40 firms with serious violations (see Appendix B). Announcement of formal investigation is commonly followed by a negative abnormal return of stock prices.

Although the accounting scandals have been frequent, there is just little research concerning these particular issues in Indonesia. A very early written report by Mayangsari and Sudibyo (2005) explains the likelihood of an auditor to be sued because of passing financial statements containing material errors. It is followed by several articles and research on the likelihood of accounting fraud of listed firms and SOEs (Chariri 2007; Soselia & Mukhlisin 2008; Thoyibatun, Sudarma & Sukoharsono 2009; Wilopo 2006); earnings management (Fitriasari 2007; Nasution & Setiawan 2007; Riduwan 2009; Siregar & Utama 2008; Ujiyantho & Pramuka 2007); assets tunnelling

(Machfoedz et al. 2009); and the need for task-specific knowledge in assessing fraud cases (Tirta & Sholihin 2009). Following is a discussion of these specific issues, which need to be considered in order to deter such incidences.

Mayangsari and Sudibyo (2005) explain a case of accounting irregularities with auditee and auditor characteristics. Corporate governance mechanisms (e.g. independent board of commissioners and audit committee), financial difficulties, conservatism in accounting policy, internal control, compensation, business risk and firm size are among firms' characteristics that increase management probability to pass misleading financial statements. Additionally, accounting irregularities can be explained by auditor characteristics e.g. audit quality, auditor negligence, independence and competence. The attribution theory developed by Fritz (1958) is used to analysis these internal and external factors as the cause of management behaviour.

An internal factor such as a firm's corporate governance benefit is still mixed. Some researchers are still questioning its effectiveness to reduce opportunistic earnings management and firms' performance (Siregar & Utama 2008; Wardhani 2006). Both authors found that presence of independence board of commissioner and audit committee insignificantly influence earnings management. They argue that corporate governance mechanisms are only applied for compliance with mandatory regulation, not for improving a monitoring system within a company. They indicate that a firm with a high proportion of family ownership and non-business groups is more likely to choose efficient earning management, which is a high-value relevant financial statement. Other research findings have found a positive relationship between corporate governance attributes and a firm's performance (Nasution & Setiawan 2007; Yonnedi & Sari 2009). In other words, it should negatively associate with accounting irregularities. A poor governance mechanism (e.g. less effectiveness of independent commissioners and audit committees' roles) is one of the factors causing auditors fail to modify their opinion of misleading financial statements. The existence of 'grey audit committee'<sup>27</sup> may

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<sup>27</sup> A grey committee member is someone who has ever worked for a company, or consultant, or has a relation with management or relation within the supply-chain network. That member may be a potential source of violation of audit committee independence (Vicknair, Hickman & Carnes 1993)

persuade an auditor to issue an **unqualified opinion** even if the client has financial reporting problems. Further empirical evidence is needed to determine the external validity of corporate governance benefits.

Internal control has also been pointed out as an important variable in reducing the tendency of accounting fraud (Wilopo 2006). Using a primary data analysis, Wilopo measured internal control as a first-order construct that is reflected by several indicators. It is measured by the level of duty segregation, a transaction recording, a physical control, a sound accounting system and a monitoring & evaluation system. Wilopo's finding in Indonesia is supported by previous research in other countries (Abbott, Parker & Peter 2004; Beasley 1996; Beasley, Carcello & Hermanson 2000). To some extent, internal control is effective in deterring managerial unethical behaviour.

The Indonesian public interest in reforming executive compensation and related corporate governance structures will definitely persist. As it is an anomalous finding from generally accepted rules in agency theory (Dallas 2003; Ribstein 2002), Wilopo (2006) suggests that the executive compensation structure needs, to be carefully addressed since it is not reducing the likelihood of accounting fraud. This study claims strongly that increasing compensation, in the form of salary and or promotion, is not reducing unethical behaviour and fraud in listed companies and SOEs. Shared codes of conduct and improving management moral in reporting practices are among the proposed activities to deter fraud.

Prior studies on earnings quality show that business risk influences earnings quality (Collins & Kothari 1989; Easton & Zmijewski 1989). A company operating in a higher risk industry eventually faces higher earnings variability. Mayangsari and Sudibyo (2005) indicate that company risk and industry risk will cause reduced fairness of financial statements. Therefore, to some extent, this will increase the problem of earnings value relevance and/or more serious accounting irregularities.

The audit quality has contained the only characteristics that have attracted researchers' attention in association with the error–fraud continuum. Big Four<sup>28</sup> audit engagement is recognised as a higher quality audit opinion rather than that of non-Big Four. The past research, such as Palmrose (1984), used to indicate the Big Eight as proxy of the high-quality audit firms until 1989, before they merged with others and became the Big Four since 2002. Mayangsari and Sudibyo (2005) use the Big Four as an indicator of audit quality and find that this is negatively associated with auditor litigation, whereas some studies (Siregar & Utama 2008; Wardhani 2006) find that the Big Four are statistically insignificant toward earnings management. Further investigation is needed to specify the association of audit quality and general accounting irregularities.

An auditee–auditor relationship is also considered as an important factor causing incidence of accounting irregularities (Mayangsari & Sudibyo 2005). Reflecting agency theory, an auditor is an independent party between shareholders and management to provide a neutral view of management's financial report as the basis for arranging various contracts, such as compensation, debt–covenant ratio and other financially-related measures. However, conflict of interest arises when the auditor perceives that benefit from management is higher than shareholders do. In other words, the auditor is incapable of acting independently. Audit tenure and the presence of a non-audit service are both characteristics to determine auditor likelihood of concealing bad things from their clients (Johnson, VE, Khurana & Reynolds 2002; Knapp 1991).

Unfavourable financial conditions are also hypothesised to drive a management to manipulate earnings to avoid sanctions from creditors (Mayangsari & Sudibyo 2005). To some extent, management has an incentive to adopt aggressive accounting methods if they perceive that the firm may become financially distressed (DeAngelo, H, DeAngelo & Skinner 1994; DeFond & Jiambalvo 1994; Lambert 2001). Management might want to make up reporting earnings to secure their jobs. Gibson (1989), for example, documents that about 52% of financially distressed firms have senior management turnover during the periods surrounding corporate difficulties. Through

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<sup>28</sup> The Big Four are the largest international accountancy and professional service firms: PriceWaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG.

increasing financial performance, management could reduce the intervention of BOD or other regulatory authorities.

The relationship between company size and likelihood of accounting irregularities is debatable. The political cost hypothesis indicates that a high-growth company would tend to report lower earnings than a low-growth firm (Watts & Zimmerman 1990). However, the opposite can also happen, when a large-sized company management pays more attention to improving financial statement quality. Siregar and Utama (2008) also claim that firms that are related to non-business groups, e.g. conglomerate business groups, will more inclined to choose efficient earnings management. Further empirical evidence is still needed to clarify the relationship between size of a company and the incidence of accounting irregularities.

Some reporting scandals always exist, persist and are even done in a complex manner. Given the above theoretical points of view and strong belief in the benefit of corporate governance mechanisms, this study posits the significant impact of those variables in reducing such problems.

### **3.7 Summary**

This chapter has provided a brief preview of the Indonesian economy and stock market development, the legal foundation of corporate governance and their implementation, discussion of the country accounting systems and accounting irregularities issues in Indonesia. The country has the largest sized economy, in terms of GDP, within its ASEAN counterparts. Much earlier colonial legislation has continued to affect Indonesia, including the existence of a two-tier board structure in its corporate governance systems. Corporate governance implementation in Indonesia provides a perspective of practical implementation in the two-tier board systems. The literature has also illustrated the differences of the Indonesian version from the original ideas of the systems commonly implemented in continental Europe.

Indonesian accounting standards have evolved significantly since the 1970s. ADB (2003) claims that the standards are broadly consistent with IAS (known as IFRS), but

the World Bank (2010) indicates some gaps between them that potentially reduces the financial reporting quality. The country has very few CPAs compared with the total number of CPAs in ASEAN countries. There are more than 40,000 SRAs (similar to those with an associate membership of CPA in Australia) which are a potential resource for the accounting and auditing profession in the country.

The problem of accounting irregularities can happen everywhere including an emerging market such as Indonesia. In contrast with the effort to attract more investors within Indonesian market, revelations of poor quality of reporting earnings continue to mount in the recent decade (see Table 3.6). The widespread default of issuers' disclosure has been largely been blamed on poor corporate governance systems by for example, Djonieri (2010); Mayangsari and Sudibyo (2005); Nasution and Setiawan (2007); Wilopo (2006); Yonnedi and Sari (2009). Such studies tend to overlook the need for refining a particular governance mechanism which leads to the most severe misstatement incidences.

Although the corporate governance systems have been examined and related to financial reporting quality, few researchers have examined this topic in Indonesia. The conceptualisation of the accounting–legal relationship needs further evaluation. Past studies have investigated a particular corporate governance dimension to determine the likelihood of accounting irregularities. Considering that cases of accounting irregularities might occur, from very simple error forms to severely fraudulent information, this study develops a conceptual framework to incorporate the ordinal level of such incidences.

Using BAPEPAM-LK law enforcement as the level of violation seriousness, this study develops a model to predict which corporate governance dimensions would likely deter such serious accounting irregularities by management. In the next chapter, the research framework used to guide the research is outlined.

## **CHAPTER 4 RESEARCH FRAMEWORK**

### **4.1 Introduction**

In the previous chapters, the literature relating to corporate governance in Western countries, the incidence of accounting irregularities, the development of Indonesian corporate governance and the misstatement of financial reporting in Indonesia were reviewed. The objective of this research is to investigate the influence of individual corporate governance dimensions and also governance as a system on the likelihood of accounting irregularities in Indonesian two-tier board systems, which is an infrequently researched area in corporate governance and financial reporting practices. Moreover, the two-tier board system of corporate governance is investigated to contribute to the literature, which is mostly available in the one-tier board system. Therefore, the research framework used to guide the research is outlined. This chapter is organised in the following manner: first, the research question, which was indicated in Chapter 1, will be explored in further detail and broken into five sub-subsections which are necessary to answer the research question; second, the research framework is outlined; and finally, the hypotheses are developed.

### **4.2 Research question**

Generally, financial statements are prepared by management and verified according to accounting and auditing standards. However, there are always incidences where companies commit wrongdoing in financial reporting to manipulate accounts. Regarding this issue, effective corporate governance mechanisms theoretically could deter serious accounting irregularities. In an unitary board system, Smaili and Labelle (2009) found that issuers in default have less effective corporate governance systems. The seriousness of accounting irregularities is more severe when firms: (1) have fewer independent directors on their board, audit committee and no block holders; (2) have recently changed their auditors; (3) have a CEO who is also board chairman; and (4)

show poorer communication between their audit committee and auditors, while having large financial needs.

As mentioned earlier, many studies in developed countries have addressed this issue in unitary board systems, but not in the two-tier board systems that are common in civil law countries (LaPorta et al. 2000; Sama & Shoaf 2005) including Indonesia (Tabalujan 2002). Therefore, the main research question that arises from this study is:

*What is the effect of individual corporate governance dimensions and corporate governance as a system on the gravity of incidence of accounting irregularities in Indonesia?*

This study takes into consideration that the institutional setting of Indonesia in fact is different from the practice of corporate governance in common law countries. Within internal governance mechanisms, there is a board of commissioners (BOC) and a board of directors (BOD) in each limited corporation, instead of a single board of directors. Hence, it is necessary to investigate:

1. boards of commissioners' effectiveness in curbing the gravity of accounting irregularity incidences in Indonesia
2. audit committees' effectiveness in curbing the gravity of accounting irregularity incidences in Indonesia
3. boards of directors' effectiveness in curbing the gravity of accounting irregularity incidences in Indonesia
4. the effect of external auditor quality on curbing the gravity of accounting irregularity incidences in Indonesia and
5. the effect of the interaction of board of commissioners, their audit committee and auditors on the gravity of accounting irregularity incidences in Indonesia.

This thesis aims to fill the knowledge gap in the literature by providing a detailed analysis of the relationship between corporate governance mechanisms and the incidence of accounting irregularities in Indonesian two-tier board systems. Additionally, this research aims to provide knowledge and insights for policymakers



and regulators to help strengthen Indonesian law enforcement by providing additional empirical evidence of corporate governance characteristics of those reporting issuers identified as being in default or committing various level of accounting irregularities.

### **4.3 Conceptual framework**

For that reason, the main objective of this study is to investigate the influence of individual corporate governance dimensions and corporate governance as a system on the likelihood of accounting irregularities in Indonesia. This research empirically develops a model to explain why some companies succumb to certain degrees of accounting irregularities whereas others do not, by examining the BAPEPAM-LK's enforcement actions.

This study uses the severity of the sanction imposed by BAPEPAM-LK on those who commit fraudulent financial reporting in order to develop a sanction level of accounting irregularities (LAI) measure, as shown in the middle portion of the conceptual framework presented in Figure 4.1. An effective corporate governance mechanism is expected to have a negative association with various levels of accounting irregularities incidences, along with their corresponding BAPEPAM-LK disciplinary sanctions.

According to BAPEPAM-LK, those who commit accounting irregularities are placed on a "law enforcement list" in BAPEPAM-LK's annual report. In less severe cases, BAPEPAM-LK issues an admonition letter (e.g. to restate financial statements, to implement an accounting method and/or to disclose particular information). In more serious cases where the deficiency cannot be corrected, the Commission keeps these issuers under investigation. The most serious breaches are referred to local courts as a further enforcement action.

Effective corporate governance is measured by the nature of a firm's corporate governance mechanisms, such as to what extent their board of commissioners, audit committee, board of directors and auditor ensure efficient performance and responsible behaviour. Previous literature has brought to light that accounting irregularities are often associated with poor corporate governance practices. Scholars commonly examine

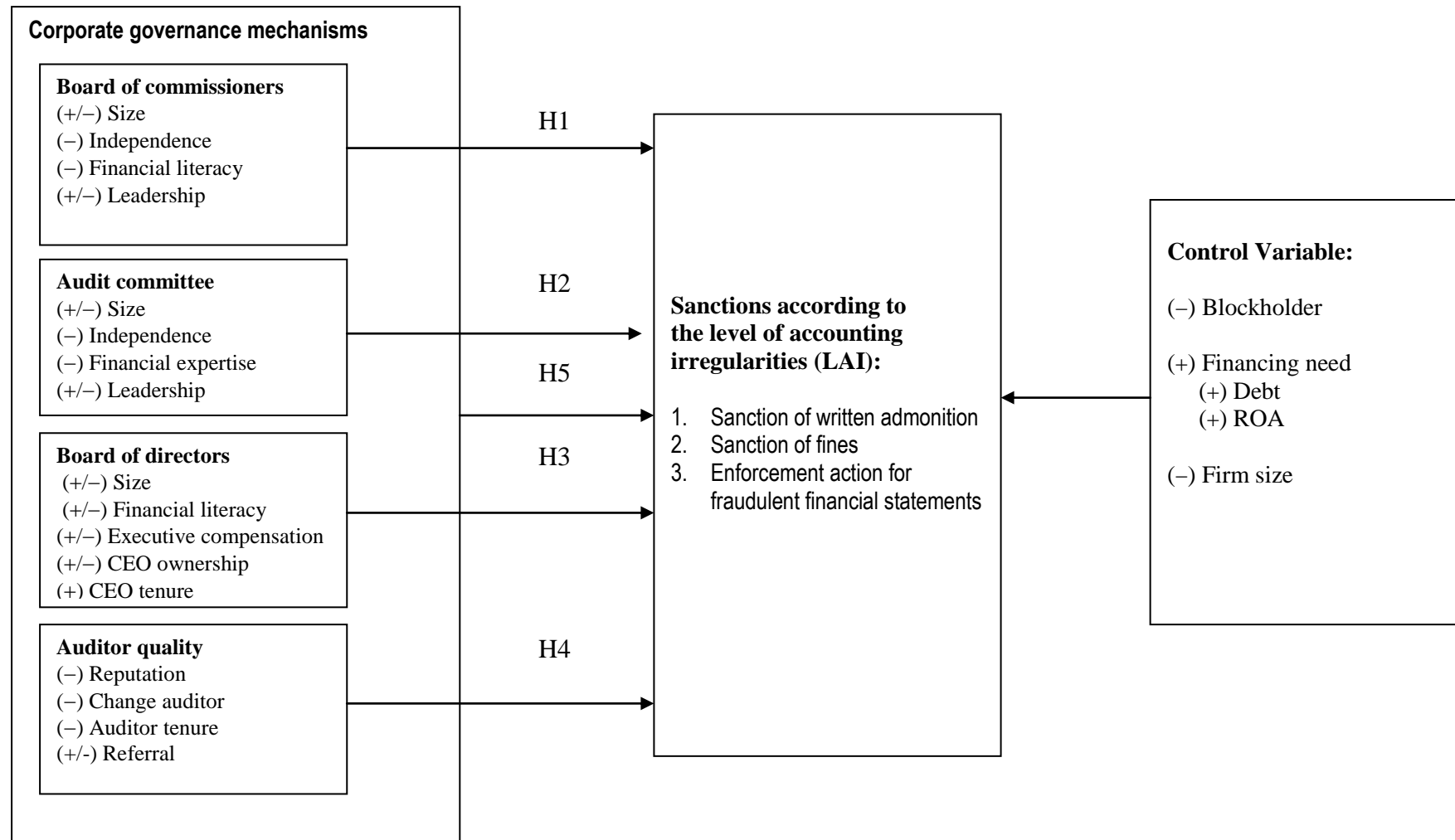
individual governance characteristics such as the board (Beasley 1996), audit committee (Abbott, Park & Parker 2000; Abbott, Parker & Peter 2004) or auditor (Carcello & Nagy 2004; Farber 2005; Johnson, VE, Khurana & Reynolds 2002; Myers, Myers & Omer 2003; Piot & Janin 2005), and also the interaction of governance dimensions as a system (Chen et al. 2006; Smaili & Labelle 2009).

This study uses the institutional setting of the Indonesian two-tier board system, in particular to contribute to knowledge by identifying the specific governance dimensions' role in curbing the incidence of accounting irregularities. In accordance with prior studies and literature reviewed in Chapters 2 and 3, the key variable dimensions including board of commissioners, audit committee, board of directors and auditor have been incorporated into the research framework illustrated in Figure 4.1. The left portion of the figure is internal mechanisms that complement external market mechanisms such as institutional or other outside block holder ownership presented in the right portion of the figure. This framework includes other control variable for firms' financing requirement, indebtedness and also firm size.

#### **4.4 Hypothesis development**

In addition to the above theories predicting the likelihood of accounting irregularities, scholars commonly agree that the opportunity to make misstatements increases when a corporation has a poor corporate governance mechanism (Abbott, Parker & Peter 2004; Beasley 1996; Beasley et al. 2000a; Farber 2005; Jensen 1993). Furthermore, agency theory posits that the presence of an independent director or non-executive directors can improve board performance, to safeguard the interests of shareholders and minority interests. Firms with a high percentage of non-executive directors have fewer financial statement scandals, since the presence of independent directors reduces the unethical behaviour of executive directors. The following subsection addresses the relationship between these governance mechanisms and its effect on minimising or even deterring the incidence of accounting irregularities.

**Figure 4.1 Conceptual framework of the link between corporate governance mechanisms and the level of accounting irregularities**



#### **4.4.1 Effectiveness of board of commissioners and audit committee**

In Indonesia, a limited liability company is required to have a two-tier board, consisting of a board of commissioners and board of directors. Within this system, the board of directors is exclusively composed of company executives to direct business operations (see section 3.3.2). Under the new Company Law 2007, the role of the board of commissioners is to supervise the policies and general operations of company management and to advise the company's executives. As a general understanding, the board of commissioners has similar monitoring responsibilities to those of the Anglo-Saxon board of directors. The board of commissioners is restricted from participating in making any operational decisions (Lukviarman 2004; Robinson 2009; Tabalujan 2002; Wibowo 2008).

An effective board of commissioners plays a crucial role in corporate governance to achieve company goals. A few studies have been undertaken concerning the dimensions of an effective board of commissioners (supervisory board). Considering that the function of a board of commissioners is similar to that of a board of directors in a one-tier board system, there are a number of studies that examine characteristics of the board's power, independence and competence related to the likelihood of accounting fraud. Farber (2005) argues that the presence of financial experts in the boardroom minimizes the seriousness of accounting fraud. Previous studies (e.g. Beasley 1996; Beasley et al. 2000a; Lukviarman 2004) assert that the proportion of independent directors in fraudulent firms is likely to be smaller than in compliant firms.

Other studies also reveal that accounting irregularities are less likely to occur with small board size, long director tenure, and duality of chairperson–CEO. Jensen (1993) suggests that board size increases as the likelihood of corporate fraud increases. The rationale behind this finding is that a smaller board provides more of a controlling function than a larger board. Moreover, when turnover is high, there will be only a few employees (senior staff) remaining who can recall the corporation's fraudulent activity. Few new employees are likely to join the power elite, thereby fostering insider power (senior staff) to institutionalise their position of power within the corporation (Dunn 2004). Regarding chairman–CEO duality, Dunn (2004) also argues that structural

power, when managers also sit as key people in the board, negates the advantages of a division of labour and can lead to adverse corporation outcomes.

By comparing this to the dimensions of boards of directors in a one-tier structure and adapting it to Indonesian legal requirements, this study develops a board of commissioners score (BOC score) to rate the likelihood of accounting irregularities. This score is used to empirically test the following hypothesis, in alternate form:

*H1: The board of commissioners' effectiveness is negatively associated with the gravity of incidence of accounting irregularities.*

The system uses board committees to assist the board of commissioners, instead of the board of directors such as in the unitary board system. Committees commonly take the form of audit committees, nomination and remuneration committees, and risk-management committees. The National Committee for Governance or NCG (2006) requires audit committees to assist the board of commissioners to ensure a company complies with internal and external accounting and auditing matters. The audit committee is chaired by an independent commissioner and the members may consist of commissioners and/or professionals from outside the company. One of the members should have an accounting and/or finance background.

Audit committee effectiveness is negatively associated with the occurrence of corporate fraud (Abbott, Parker & Peter 2004; Agrawal & Chadha 2005; Baxter 2007; Farber 2005). The committee's effectiveness is commonly measured by the number of outside directors and number of financial experts. For instance, the Australian Stock Exchange (ASX 2008) also states the importance of independence and competence of audit committees. International practice is moving towards an audit committee only comprised of independent directors. Regarding technical expertise, the audit committee should include members who are all financially literate, with at least one having an accounting qualification and one who understands the industry practice in which the corporation operates. Therefore, this study is intended to develop a score for audit committee effectiveness (audit score) to test the following hypothesis:

*H2: The audit committee's effectiveness is negatively associated with the gravity of incidence of accounting irregularities.*

#### **4.4.2 Effectiveness of board of directors/management**

In a two-tier board system, the term 'board of directors' refers to the board of management which is responsible for running daily activities (Kamal 2008). In a similar institutional setting, Du Plessis (2005) states that the German board of management is "elected and dismissed" by the board of commissioners. This situation is argued to give shareholders an opportunity to nominate representatives to protect their interest against executive directors. Therefore, the existence of election and dismissal rights of boards of commissioners is argued to be the cornerstone of boards of commissioners' monitoring effectiveness over boards of directors.

Compared to Germany, there are slightly different mechanisms in Indonesian corporate governance. Both boards of directors and boards of commissioners are appointed by a General Meeting of Shareholders. Kamal (2008) explains that the Indonesian board of commissioners only has the power to suspend members of the board of directors, whereas in Germany they have election and dismissal rights. Furthermore, unlike their German counterpart, the Indonesian board of commissioners cannot permanently dismiss members of the board of directors even when they disadvantage the company. Hence, the uniqueness of the board of directors' position in Indonesian legislation encourages further questioning of its effectiveness dimensions.

Much literature on board effectiveness seems to have concentrated on the board of directors in a one-tier board system and somewhat neglected this issue in a two-tier board system. As Indonesia uses a two-tier board system, boards of commissioners have a similar dimension to those of the one-tier Anglo-Saxon boards of directors. However, there is inconclusive evidence of the effectiveness of boards of management in a two-tier system legal environment. Therefore, as Indonesian boards of directors have a similar function to that of the CEO and executive directors in Anglo-Saxon countries,

the effectiveness of Indonesian boards of directors may be measured by applying a survey of effective executive directors from the Anglo-Saxon one-tier board system.

There are some circumstances under which the Indonesian board of directors may be able to effectively exercise its duties. Among other things, the Indonesian GCG Code provision (2006) mentions that: (1) the composition of the board of directors shall be of sufficient size that suits the complexity of the business; (2) the members of the board of directors must be professional in terms of capability and integrity; (3) the role of board of directors shall cover five main tasks, including area management, risk management, internal control, communication, and social responsibility; and (4) the requirement to prepare accountability reports by board of directors. Moreover, some scholars argue that executive compensation (Barkema & Gomez-Mejia 1998) and CEO tenure (Smaili & Labelle 2009) determine the degree of corporate governance implementation. This study incorporates the NCG guidelines and previous research to measure board of directors' effectiveness by developing a BOD score to rate the likelihood of accounting irregularities. This score is employed to empirically test the following hypothesis, in alternate form:

*H3: There is an association between the Indonesian board of directors' dimensions and the gravity of incidence of accounting irregularities.*

#### **4.4.3 Role of auditor effectiveness**

Some studies argue that the auditor plays a crucial role in preventing and detecting accounting irregularities. Among corporate governance mechanisms, auditor effectiveness is an important attribute in ensuring that market participants have confidence in published financial statements. Furthermore, auditor reputation and independence, existing referrals of the parent company auditor, change of auditor and auditor tenure are important for maintaining audit quality (Farber 2005; Johnson, VE, Khurana & Reynolds 2002; Myers, Myers & Omer 2003; Piot & Janin 2005).

Firms audited by one of the Big Four auditing firms (PriceWaterhouseCoopers, Ernst & Young, KPMG and Deloitte Touche Tohmatsu) less often announce fraudulent financial

reporting compared to firms audited by non-Big Four firms (Farber 2005). The Big Four are often used as a proxy of reputation and independence (Dopuch, King & Schwartz 2003). As the reputation of non-Big Four firms does not always represent poor audit quality, other attributes of the auditor dimension need to be considered.

Change of auditor, referral and auditor tenure are among the important things associated with audit quality. Firstly, Piot and Janin (2005) state that the occurrence of restatement is frequently preceded by a change of external auditor. However, a situation where change of auditor is caused by referral may constitute a better level of audit quality (Branson & Breesch 2004). Secondly, longer auditor tenure constrains management's discretion with accounting accruals, which suggests high audit quality (Carcello & Nagy 2004; 2003). This is consistent with Johnson, Khurana and Reynolds (2002) who find that accruals are larger and less persistent for firms with short auditor tenure relative to those with medium or long tenure. They argue that longer tenure can improve auditor expertise from superior client-specific knowledge.

This present research proposes reputation, auditor change, referral and audit tenure as measurements of audit quality. Therefore, this study will summarize auditor dimensions with an auditor score to test the following hypothesis:

*H4: The auditor's effectiveness is negatively associated with the gravity of incidence of accounting irregularities.*

#### **4.4.4 Corporate governance mechanisms as a system**

As suggested by Smaili and Labelle (2009), rather than only investigating individual corporate governance mechanisms such as the individual board (Beasley 1996; Beasley, Carcello & Hermanson 2000), audit committee (Abbott, Park & Parker 2000; Abbott, Parker & Peter 2004), or auditor (Carcello & Nagy 2004), it is important to consider that corporate governance mechanisms interact. Therefore, this study utilises a score as indicated in previous sections to explore the interaction effect on the likelihood of misreporting practices. Here it is hypothesised that interaction between prominent characteristics of corporate governance mechanisms may prevent the incidence of accounting irregularities:



*H5: The interaction between the effectiveness of the board of commissioners, audit committee, board of directors and auditor is negatively correlated with the gravity of incidence of accounting irregularities.*

Finally, in order to determine the relationship between Indonesian corporate governance mechanisms and the likelihood of accounting irregularities occurrence, factors such as financial need, presence of block holders and firm size are included.

#### **4.4.5 Other factors explaining accounting irregularities**

A various number of variables have a potential effect on the relationship between corporate governance mechanisms and seriousness of accounting irregularities. Apart from the aspects of corporate governance described above, factors including financial need, presence of block holders and firm size are included in the model for this study.

It is presumed that financially distressed companies have the same relation to the likelihood of fraudulent financial reporting (Carcello & Neal 2003; Wardhani 2006). Since similar proxy statements from the US (Dechow, Sloan & Sweeney 1996) are not publicly available in Indonesia, a firm's financial need is measured by debt ratio and the firm's performance. Moreover, the presences of a non-affiliated block holder on the board and company size are both factors that influence financial reporting unethical behaviour (Chen et al. 2006; Siregar & Utama 2008). Previous studies have found that these dimensions may be associated with the likelihood of severity of the financial reporting incidences.

##### **4.4.5.1 Ownership concentration**

Existence of block holders in firm ownership to some extent can benefit a company and consequently all shareholders (Lukviarman 2004). Previous studies have found that institutional ownership or legal entity investors have become progressively more willing to exercise their voting rights to put pressure on managers to act in the best interest of investors (Cornett et al. 2007). It is apparent that as this kind of investors increases its ownership proportion, it tends to have greater role in the disciplining, monitoring and

guiding of the manager's behaviours. Therefore, it is believed that its existence may reduce agency cost (Jensen & Meckling 1976).

In emerging markets, including Indonesia, a company founder or a related party often retains control over a company, even if it has been listed on a stock market (see Chen et al. 2006). Therefore, individual block holders might be compromised as monitors of the corporation. Powerful block holders could influence reporting of corporate decisions that may arise from controlling family owners. Since listed firms in Indonesia are mostly concentrated within a family or group, it is important to consider the effect of individual block holders (more than 5 percent<sup>29</sup>) on governance.

In this study, insider ownership is investigated as part of board effectiveness, while outsider ownership is considered one of the control variables. Some studies mention that outsider ownership is separated into ownership by a legal entity (institutional) and individual independent shareholders holding more than 5 percent of shares. As mentioned earlier, institutional ownership is expected to improve overseeing activities. The effect of individual block holders seems inconclusive (Chen et al. 2006; Cornett et al. 2007; Firth, Fung & Rui 2007).

#### **4.4.5.2 Financial needs**

An unfavourable financial situation is one of motivations for earning manipulation. In positive accounting theory mainstream, the bonus hypothesis and debt hypothesis have received most support to explain and predict managers' passing an erroneous financial information (see Watts & Zimmerman 1990). In addition to the academic mainstream, Dechow, Sloan and Sweeney (1996) put a practitioners' points of view that earning manipulations are intended to influence investors in investment and lending decisions. Wells (2005, p.289) states that a common reason for management to make a fraudulent financial statement is "to conceal true business performance". Again, since similar proxy statements from the US are not publicly available in Indonesia, this study considers leverage ratio and firm's performance as financial need measurements.

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<sup>29</sup> Capital Market Law 1995 article 87.

A debt covenant hypothesis mentions that the closer a firm is to violation of accounting-based debt covenant; the more likely the firm's manager is to shift accounting choices to favour their discretion. The higher a firm's leverage, the more risky the firm appears to be. Using the same reasoning, a higher leveraged firm needs more financial support. In a univariate analysis, Dechow, Sloan and Sweeney (1996) find that fraudulent firms have more financial need than control firms.

Firms are more likely close to erroneous financial statements when they are financially distressed (Carcello & Neal 2003) and have worse performance (Evans, Evans & Loh 2002). A corporation with declining performance faces greater scrutiny from both investors and creditors. Therefore, it is more likely to respond with either fraudulent financial reporting or improvement of its governance structure.

#### **4.4.5.3 Firm Size**

Although government attention emphasises large firms in relation to the subject of financial manipulation (Dechow, Sloan & Sweeney 1996), most researchers have found that small-sized firms have more incentive to engage in financial manipulation (Albrecht & Richardson 1990; Jensen & Meckling 1976; Siregar & Utama 2008; Watts & Zimmerman 1990).

First, larger firms are more likely to provide a higher quality of earnings since they are more visible to the public (Watts & Zimmerman 1990). Managers face very costly reputation damage if they engage in financial misreporting conduct. The political cost is very expensive. Following a disclosure requirement and even voluntary items might reduce a firm's agency cost (Jensen & Meckling 1976). Agency theory explains that a larger company tend to disclose more information to minimise agency cost between investors/creditors and managers.

Second, share reputations are enhanced if the level of earning quality is improved. For this reason, Hossain, Perera and Rahman (1995) state that larger firms tend to have on listed status in order to maintain a liquidity (demand) for their securities. To some extent, large firms receive more attention from analysis and the public and this provides

incentive to disclose more and have a high quality of financial statement. Albrecht and Richardson (1990) find evidence that small firms have more incentive to smooth their earnings.

Third, small firms are reluctant to disclose information to the public for certain reasons. Their annual report is regarded as the only source of strategic information for competitors, creditors or governments. Therefore, management discretion in financial reporting is relatively high to protect the firm in a disadvantage situation (Raffournier 1995). Using the same reasoning, company size is likely to influence seriousness of violating financial reporting.

## **4.5 Summary**

In this chapter, detailed discussion of the research question has been explored. This research question has led to the illustration of the research framework that is employed to direct the research. The conceptual framework clarifies the relationships among the attributes of corporate governance – such as the board of commissioners and their audit committee, the board of directors and auditor quality – that impact on the instances and gravity of accounting irregularities.

In the next chapter, the set of hypotheses that eventually answer the research question are formalised. This is followed by a discussion of the operationalisation of the key variables along with determining the measurement of them. The research methodology issues are also discussed in detail, including justification of the quantitative method used to facilitate the investigation in this study.

## **CHAPTER 5 RESEARCH DESIGN**

### **5.1 Introduction**

This chapter explains the research design used to examine the hypotheses outlined in chapter 4. In this chapter, the research method employed to investigate the research question is described and justified. It is followed by discussion of the process of collecting the data, sample description, specification of matching samples, operationalisation of the research variables and analysis the data in the following subsections.

### **5.2 Justification for the Research Method**

The study adopts a quantitative method with archival data (Creswell 2009). The secondary data are in the form of BAPEPAM-LK and listed company annual reports. The measurement of the gravity of accounting irregularities is based on the type of sanctions imposed by BAPEPAM-LK. Corporate governance dimensions and other aspects are extracted from annual reports. The study summarises the characteristics of cases according to enforcement actions undertaken by the supervisory body, before furthering the analyses using univariate and multivariate analysis. More detail on the method used is given in the remaining sections of this chapter.

A number of alternative research methods that could have been used to investigate the association between corporate governance mechanisms and accounting irregularities. Since the objective of the study is to achieve a general understanding, surveys with questionnaires and case studies are the most probable alternative choices (Cohen, Krishnamoorthy & Wright 2004). Following are justification for the chosen method and a discussion of why the alternative methods were not used.

First, surveys to gather points of view of interested stakeholders on the association between corporate governance mechanisms and risk of accounting irregularities could

be undertaken. A number of prior studies (for example, James 2003; Krishnamoorthy, Wright & Cohen 2002; Wibowo 2008) have examined the broader issue, such as governance effectiveness or likelihood of fraud detection, through the use of surveys and primary data. While this method can provide useful insights, it has a number of limitations. The response rate is often low due to the study surveying sensitive areas including incidences of accounting irregularities. The other is that perceptual data could be unreliable due to respondents' tendency to be lenient and/or avoid extreme responses (Spangler & Braiotta 1990).

Second, in conjunction with this study research area, a qualitative approach with in-depth interviews could also be conducted using the case study method. The subjectivity of individuals and their biases can result in measures of the effectiveness of corporate governance mechanisms that not accurately reflect all components' true effectiveness. Since one of the study objectives is to investigate the mosaic of corporate governance mechanisms, individual cases may tend to overstate their role and understate other aspects (Spangler & Braiotta 1990).

Due to the inherent limitations of surveys and case studies, it was decided not to employ these methods for achieving this study's research objectives. Use of the archival research approach overcomes these limitations in a number of ways: (1) cost-effective with regard to different firms' location (Cooper & Schindler 1998); (2) the use of secondary data in form of regulatory data and company annual reports does not suffer from non-response bias because the researcher can access directly data from the BAPEPAM-LK and the stock market; (3) the regulatory data, so far, is the only reliable source of weighting the seriousness of cases; and (4) annual reports are prepared on the basis of representative faithfulness and contain relatively objective information.

### **5.3 Population and sample selection**

The population of this study is listed companies on the IDX. The sample consists of 78 listed companies according to BAPEPAM-LK's annual reports from 2000 to 2009. Since 2000, listed companies have been considered to be implementing the first ever country code. In addition, the 10 year period is intended to capture a sufficient number

of firms that have committed accounting irregularities<sup>30</sup>. Cases related to accounting irregularities are gathered from BAPEPAM-LK's annual reports. This study uses BAPEPAM-LK tracking of law enforcement (Figure 3.2) to identify the gravity of accounting irregularities. Additionally, corporate governance dimensions are sourced from firms' annual reports.

Firms with accounting irregularities are categorised into three groups: admonished firms; fined firms; and investigated (prosecuted) firms. BAPEPAM-LK indicates the enforcement action undertaken to issuers who have allegedly committed a reporting wrongdoing in its annual reports. BAPEPAM-LK is responsible for law enforcement to protect investors under Law 8/1995 in the IDX. According to this law, BAPEPAM-LK is authorised to impose sanctions according to the level of seriousness (see Figure 3.2). The sanctions range from administrative sanctions to referring a case to prosecutors. A written admonition is the most weak form of administrative sanction, whereas an administrative sanction in the form of a fine is a moderate sanction. The most serious case is referring to the courts to impose a sanction on issuers committing financial statement fraud. In order to create a comparison sample, companies with no accounting irregularities are included as control samples. They are similar to fraudulent reporting firms in size and within the same industry (Beasley 1996, p. 450).

Each corporate governance attribute is indicated from annual reports to measure the quality of firms' corporate governance. Board of commissioners (BOC) effectiveness is measured by seven variables: (i) percentage of independent commissioners on the board; (ii) BOC's share ownership; (iii) presence of block holders; (iv) number of commissionerships in other companies; (v) presence of financial experts on the board; (vi) number of financially literate members of the board; and (vii) BOC's leadership

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<sup>30</sup> BAPEPAM's annual report and website currently provide only significant cases in its Law Enforcement Action report and Press Releases. This policy is different from what is practised by Canadian Securities Administrators, which maintain a 'Re-filing and Error List' consisting of reporting issuers in default (see link: <http://www.osc.gov.on.ca/en/22198.htm>, accessed on 8 September 2010). In the US, the General Accounting Office (GAO) of the SEC also provides a report entitled GAO-03-138 Financial Statement Restatement Databases. In Australia, Australian Securities & Investment Commission (ASIC) maintains its Enforceable Undertaken (EU) register consisting of companies and persons in violation 93A of the Australian Securities & Investments Commission Act 2001. Canada, the US and Australia made these databases publicly available.

(see section 3.4). Furthermore, audit committee effectiveness is, as a subordinate of BOC, determined by four variables: (i) number of unrelated commissioners on the committee; (ii) committee's leadership; (iii) presence of audit expert; and (iv) presence of financially literate members of the committee (see Smaili & Labelle 2009).

Moreover, as the Indonesian board of directors is the board of management, this board's quality is measured by five variables: (i) number of executive directors; (ii) number of directors who are financially competent; (iii) CEO integrity as to ownership and tenure; (iv) existence of internal control function; and (v) executive directors' compensation. Lastly, auditor quality is measured by four variables: (i) auditor reputation; (ii) change of auditor; (iii) existence of referral; and (iv) auditor tenure (see NCG 2006; Smaili & Labelle 2009).

In particular, scoring of the governance dimension is used to measure the quality of sample governance implementation based on the best practices of the current code and regulations. As suggested by Chen et al (2006) and Smaili and Labelle (2009), the study will develop scores for BOC, audit committee, BOD and audit quality.

BOC score ranges from 1 to 3, with 3 is the highest board of commissioners' score. A BOC score of 3 is assigned for a firm when the president is not affiliated (independent commissioner), the proportion of unrelated members is more than 30 percent and there is at least one financial expert present on the board; 1 is assigned when the president is affiliated, the proportion of unrelated members is less than 30 percent and there is no financial expert on the board; and 2 is assigned in all other cases.

An audit score of 3 is assigned for a firm when the audit committee leader is a financial expert and the percentage of membership of financial experts and/or financial competence is more than 66 percent; 1 is assigned when the leader is not either a financial expert or financially competent; 2 in all other cases. A BOD score of 3 when there are financially competent director(s) and an internal control system is established; 1 when there are no financially competent director(s) and an internal control function is not established; and 2 in all other cases. Lastly, an auditor score is 3 when an auditor is



part of the Big Four firms with no change of auditor; 1 when an auditor is not affiliated with the Big Four firms with a change of auditor prior to the incidence; and 2 in all other cases.

**Table 5.1 Summary of main sample selection**

Cases handled by BAPEPAM-LK	Imposed sanction to issuers			Selected sample
	Warning	Fined	Prosecuted	
Total cases (identified) in 2000	0 (0)	164 (0)	39 (1)	1
Total cases (identified) in 2001	108 (0)	130 (0)	44 (4)	4
Total cases (identified) in 2002	4 (0)	186 (16)	44 (1)	17
Total cases (identified) in 2003	0 (0)	5 (6)	0 (3)*	9
Total cases (identified) in 2004	0 (0)	315 (6)	51 (0)	6
Total cases (identified) in 2005	0 (0)	160 (6)	36 (0)	6
Total cases (identified) in 2006	0 (0)	150 (6)	16 (3)	9
Total cases (identified) in 2007	0 (0)	136 (11)	39 (2)	13
Total cases (identified) in 2008	1 (0)	212 (5)	67 (1)	6
Total cases (identified) in 2009	14 (0)	288 (6)	11 (1)	7
Final sample size				78

Source: BAPEPAM-LK's annual reports 2000–2009.

\* In 2003, samples are indicated in 2004 and 2005, since those cases were under investigation and sanction process.

Table 5.1 provides a summary of a sample selection consisting of 78 issuers indicated on BAPEPAM-LK's annual reports from 2000 to 2009. As this study focuses on the incidence of misstatements, the samples are determined by cases related to issuers and public-listed companies' disclosures only<sup>31</sup>. The table provides the total cases handled by BAPEPAM-LK and also the number of cases indicated (named) in its annual reports. Those indicated in BAPEPAM-LK's annual reports are the only valid sample, instead of the total number cases, which are confidentially kept by the BAPEPAM-LK office.

## 5.4 Sample description

The 78 issuers' disclosure of default, half of the 156 total samples, is distributed across a wide variety of Indonesian industries as shown in Table 5.2. The largest group of companies (34 or 43.58%) is concentrated in the finance sector and the trade, services

<sup>31</sup> According to the Capital Market Law 1995, BAPEPAM-LK may conduct a civil investigation and a criminal investigation toward violations and crime against the law. Cases handled by BAPEPAM-LK include those related to: (1) issuers and public-listed companies' disclosures, (2) securities transactions and institutions and (3) investment management.

and investment industry. This is followed by 20 companies (40%) in the manufacturing industry. The consumer goods industry was the third largest with 11 firms (14.10%). Representations from other industries are presented in Table 5.2.

**Table 5.2 Distribution sample by industry**

JASICA*	Industry classification	N	%
1	Agriculture (11-19)	2	1.28
2	Mining (21-29)	4	2.56
3	Basic industry and chemical (31-39)	20	12.82
4	Miscellaneous industry (41-49)	20	12.82
5	Consumer goods (51-52)	22	14.10
6	Property, real estate and building construction (61-69)	12	7.69
7	Infrastructure, utilities and transportation (71-79)	8	5.13
8	Finance (81-89)	34	21.79
9	Trade, services and investment (91-99)	34	21.79
Total sample		156	100.00

Source: BAPEPAM-LK's annual report 2000–2009.

\*JASICA stands for the Jakarta Stock Industrial Classification

## 5.5 Matching procedure

To create a control group, each issuer in default was matched with a compliant firm on the basis of industry (two-digit JASICA code) and size (total assets). The control sample was paired on size and industry due to these influences on the earnings management (Beasley 1996; Beasley et al 2000a). According to Beasley, firm size similarity is about  $\pm 30$  percent of the total size of disclosure in default firms in the year of incidence. Industry is also taken into account in choosing a matched sample, since Beasley et al. (2000a) find that fraudulent financial reporting may be a function of industry traits. If within a two-digit industry a matching sample is not available, a one-digit JASICA code is considered<sup>32</sup>.

The firms that committed accounting irregularities and matched firms of similar size produce values  $t=0.462$  with  $p$ -value 0.645, suggesting that the matching method is successful. The average size of fraudulent firms (LnSIZE) is 27.310 (median 27.560)

<sup>32</sup> Matched samples may suffer their reliability and the study could choose one of the total cases reported by BAPEPAM-LK. This is caused by unavailability of sample frame indicated issuers with disclosure in default.

and 27.270 (median 27.750) for compliant firms. Since size is log transformed, the average IDR value of fraudulent firms is IDR5,199,955 million (median IDR932,500 million) and IDR3,250,668 million (median IDR1, 122,500 million) for non-fraudulent issuers.

## **5.6 Research variables**

### **5.6.1 Dependent variables**

This research considers a method for more than the categorical responses commonly used in binary values in logistic regression analysis (e.g. Abbott, Parker & Peter 2004; Beasley 1996; Sharma 2005). Since the severity of accounting irregularities is measured with the level of BAPEPAM-LK's sanctions of accounting irregularities (LAI), which is an ordered categorical variable, this study uses an ordinal logistic regression analysis. LAI takes the value of 0 for matching samples, 1 for admonished firms, 2 for fined firms and 3 for firms referred to prosecutor because of fraudulent financial reporting. The measurement is developed using the same order as in Smaili and Labelle's study (2009).

### **5.6.2 Independent variables**

There are four groups of independent variables in this research: the board of commissioners' characteristics; audit committee characteristics; the board of directors' characteristics; and auditor quality.

The first group of independent variables, the board of commissioners' (BOC) characteristics, is operationalised into seven empirical indicators: proportion of independent members on the BOC (*unrelated*); BOCs' ownership (*ownerBoC*); presence of block holders (*blockingBoC*); number of commissionerships in other firms (*NSeat*); financial experts on BOC (*BoCexpert*); financial literates on BOC (*BoCComp*); and BOC's leadership (*BoCLeader*).

As the BOC is responsible for the oversight role over a firm's management, the degree of its independence (*unrelated*) is measured by the proportion of independent or outside members on the board. Independent members are defined as commissioners who (i)

have no affiliation relationship and (ii) do not have a business relationship with the firm's core business (Wibowo 2008)<sup>33</sup>. In the one-tier board system, a high level of independent directors is negatively associated with incidence of fraudulent financial statements (Beasley 1996; Beasley et al. 2000a), earnings management (Klein 2002) and financial statements restatements (Agrawal & Chadha 2005).

In addition to the percentage of independent members of the BOC, there are other factors to consider that affect BOC effectiveness. For example, a low percentage of shares owned by BOC (usually affiliated members) might discourage them from taking a more active role in overseeing managers (see Jensen 1993; Uzun, Szewczyk & Varma 2004). US evidence reveals that outside directors hold a small portion (only 1.4%) of company shares (Ahmed & Duellman 2007). *OwnerBoC* is investigated using the percentage of shares held by BOC members.

Block holders on the board is another important dimension of an effective BOC. Following Abbott, Parker and Peter (2004), the presence of block holders is expected to be negatively associated with the occurrence of financial restatements. As mentioned in the previous chapters, BOC are becoming more aggressive in exercising their voting rights to pressure management on the best interest of block holders (Cornett et al. 2007; Smaili & Labelle 2009). *BlockingBoC* is investigated using the number of non-affiliated block holders on the BOC. In an emerging economy such as Indonesia, their existence might mitigate the dominance of BOC members affiliated to management (see Chen et al. 2006).

In addition to boards' independence and power, a competent BOC minimises accounting irregularities' gravity and prevents their occurrence. The main proxies used for this characteristic are the following three variables: (i) number of seats (*Nseat*) that commissioners or directors hold in other firms (Beasley 1996; Smaili & Labelle 2009);

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<sup>33</sup> Since Indonesia is the study context, the definition of 'independent commissioner' is similar to that of 'independent director' in unitary board systems. The Indonesia Stock Exchange requires listed firms to have independent commissioners as at least 30% of the composition of the BOC (article III.1.4). In addition, Bank of Indonesia requires its composition a no less than 50% of the number of BOC, and former directors or executive officers can only be independent commissioners after a cooling-off period of 1 year (Bank Indonesia 2006).

(ii) number of financial experts (*BOCexpert*) and/or financially literate members (*BOCComp*)<sup>34</sup> on the board (Farber 2005; Levitt 1999); and (iii) board leadership structure (*BOCleaders*). Since the separation between chairman and CEO is compulsory in a two-tier board system, this study proposes the value 1 if the chairman (known as president of commissioners) is an independent commissioner and the value 0 otherwise.

The second group of independent variables is audit committee characteristics. This variable is operationalised into five empirical dimensions: number of committee members (*size*); proportion of independent BOC members (*unrelatedaudit*); committee's leadership (*auditleader*); presence of financial experts (*auditexpert*); and financially literate members (*auditcomp*) on the committee.

The number of audit committee members (*Nseat*) is often associated with the ability of the committee to carry out its role in reviewing information prior to the BOC approval. Since non-commissioner members are eligible<sup>35</sup>, the proportion of independent BOC members (*unrelatedaudit*) is measured using the number of independent commissioners on the committee divided by the total number of member of the audit committee.

The other important characteristic of an audit committee is members' expertise. As the main committee role is to assist and review financial information for the BOC, this study investigates the committee chairman's financial expertise. This study assigns the value 1 if a committee's chairman (*auditleader*) is either a financial expert or financially literate; and the value 0 for all other case. Moreover, this also investigates "financial expertise" as defined by the Sarbanes-Oxley Act (2002), where a "financial expert" is:

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<sup>34</sup> *Peraturan BAPEPAM Nomor IX.I.5/2004 tentang Pembentukan dan Pedoman Pelaksanaan Kerja Komite Audit*. This study advocates disclosure of employing a financially expert member not only on audit committees, but also on the Indonesian board of commissioners. A recent development seems to ignore benefits of the presence of members with financial expertise on the board of commissioners. This regulation requires only one audit committee member to have a specialised university degree in accounting or finance (see article 3.6.2 of this regulation).

<sup>35</sup> According to the above BAPEPAM-LK regulation, audit committees of Indonesian firms must consist of at least 1 independent commissioner and another 2 outside professional members.

a person has, through education and experience as a public accountant or auditor or a principal officer, comptroller or principal accounting officer of an issuer, or from a position involving the performance of similar function

Like Smaili and Labelle (2009), this study considers a financial expert on the basis of two variables to differentiate financially expert members from financially literate ones. The *auditexpert* variable represents the number of audit committee members with accounting (finance) degrees or a professional designation in accounting or finance (such as CPA, CFE, CFA or CPMA). Financially literate member variable (*auditcomp*) is the number of committee members with a business/management or an economics university education or with experience in accounting and finance.

The third group of independent variables is the board of directors (BOD), in Indonesia also well-known as the *direksi*. The *direksi* is a group of executive directors that run a firm's daily operation. The variables are measured by six empirical dimensions. They are: number of executive directors (*size*); professional competence (number of directors with financial literacy [*directorcomp*]); integrity (*CEO tenure* and *executive ownership*); existence of internal control taskforce (*ICFR*) that is responsible for the *direksi*; and the level of executive compensation (*executivecomps*).

The last group of independent variables is the quality of auditors. Their characteristics are measured by four empirical dimensions: auditor reputation (*Big4*), change of auditor (*auditchange*); holding firm's auditor recommendation (*referral*); and auditor tenure (*audittenure*). This study classifies auditor's opinion (*opinion*) of the value 1 if a firm has unqualified assertion and 2 for all other cases. Types of audit opinion are included at univariate analysis as additional characteristic of the sample's summary.

External auditors take action as an external governance mechanism by assuring the high quality of financial statements (Carcello & Nagy 2004; DeAngelo, L 1981; DeFond & Subramanyam 1998). The US SEC alleges that a growing number of audit failures are caused by lack of auditor independence (Bonner, Palmrose & Young 1998; Lavalley 2002). This might be due to financial dependence on the client. Therefore, this study investigates the Indonesian context of auditor independence and reputation by following

Farber (2005). This study uses a dummy variable (*Big4*) to capture auditor reputation, valued 1 if the firm is audited by one of the Big Four auditors, and 0 if not. As proxy of the Big Four auditors does not always represent a good reputation (e.g. Enron and the promulgation of SOX 2002), the following three variables are included.

As there is an increasing litigation risk against audit firms, mandatory auditor rotation is used to reduce auditor–client dependency. As a result, the quality of audit may be investigated around auditor change (Lazer, Livnat & Tan 2004), presence of a referral from a holding company’s auditor (Branson & Breesch 2004) and audit tenure (Myers, Myers & Omer 2003). Following the previous study, *auditchange* is valued 1 if there is an auditor change prior to case detection and 0 otherwise. *Referral* is valued 1 if there is a situation where the firm appoints the same auditor as the holding company and 0 if not. Finally, *audittenure* measures the time elapsed (in years) from the end of the financial year to the date the auditor is appointed to the function.

### 5.6.3 Control variables

In addition to matching issuers in default and compliance firms on the basis of industry and asset size, this research controls for differences in firm-specific non-corporate governance features to improve the reliability of the inference process in statistical analysis. Previous researchers have found that financial requirements, ownership concentration and firm size among are the characteristics that may be associated with the likelihood of accounting irregularities.

The above three characteristics are measured by four variables. First, as the proxy statement (Dechow, Sloan & Sweeney 1996) is not publicly available in Indonesia, a firm’s financial requirement is measured by leverage ratio (*debt*) and the firm’s performance (*ROA*). Second, ownership concentration (*ownerblock*) is used to control ownership structure (Chen et al. 2006). Lastly, total assets (*size*) is used to control the effect of company size (Siregar & Utama 2008).

#### **5.6.3.1 Financial requirement**

As mentioned earlier, leverage ratio and firm's performance are used to specify a firm's financial need. Using univariate analysis, Dechow, Sloan and Sweeney (1996) have found that fraudulent firms have more financial need than control firms. Firms are more likely to be close to erroneous financial statements when they are financially distressed (Carcello & Neal 2003) and have worse performance (Evans, Evans & Loh 2002). In order to capture the degree of financial requirement, this study uses *debt* as the leverage ratio in the year of default. Declining firms' performance, as measured by ROA, is also used to provide ideal forum for analysing governance elements. Companies in decline face greater investor scrutiny and, it is speculated, are more likely to respond with either misreporting or changes in governance structure.

#### **5.6.3.2 Ownership concentration**

The existence of block holders in firm ownership to some extent can benefit a company and consequently all shareholders. Since listed companies ownership in Indonesia are mostly concentrated within a family or group, the existence of block holders (*ownerblock*) of more than 5 percent may reduce the agency problem in reporting decisions. Powerful block holders could influence reporting of corporate decisions that may arise from controlling family owners. These variables are measured as the percentage of shares held by *ownerblock* (Cornett et al. 2007; LaPorta, Lopez-de-Silanes & Shleifer 1999; Lukviarman 2004).

#### **5.6.3.3 Firm size**

As firm size is often used as a proxy of information availability in the market, information about large firms should be more available than that of small ones. In this study, it is considered that the sample may still vary from small to large firms even after the matching process. To some extent, large firms receive more attention from analysts and the public and these provide incentive to disclose more and higher quality financial statements. Albrecht and Richardson (1990) have found evidence that small firms have more incentive to smooth their earnings. *Size* is expected to have either a negative or a positive relation to the likelihood of an accounting irregularity incidence. Following



Siregar and Utama (2008), *Size* is measured as the natural logarithm of the book value of total assets.

## **5.7 Empirical analysis method**

### **5.7.1 Ordinal logistic regression analysis**

This study uses univariate and multivariate analyses to test the relationship between corporate governance mechanisms and the sanction level of accounting irregularities (LAI). In line with previous studies (Chen et al. 2006; Smaili & Labelle 2009), ordinal logit regression models are used to test the research questions since the dependent variable, LAI, is an ordered categorical variable that takes the value of 0 for matching samples, 1 for admonished firms, 2 for fined firms and 3 for firms referred to prosecutors because of their fraudulent financial reporting. Firm level is regarded as a sample unit measurement.

In the first step, this research uses univariate analysis to compare the average of corporate governance profiles of misstatement firms to that of a matched control sample of compliant issuers. Next, the average figures are compared to best practices according to the Code and related regulations in order to explore a preliminary analysis of hypotheses. Multivariate analysis (named Partial Model [PM] and Full Model [FM]) carefully analyse the relationship of corporate governance dimensions and the likelihood of accounting irregularities (Smaili & Labelle 2009).

PMs are used to investigate whether individual governance mechanisms are negatively associated with the level of accounting irregularities (LAI). PMs are used to test the research question concerning the relations between BOC (PM1), audit committee (PM2), BOD (PM3) and auditor (PM4) characteristics and LAI. In the PM1 model, this study investigates the proportion of independent BOC (*unrelated*), BOC ownership (*ownerBoC*), presence of block holders (*blockingBoC*), number of commissionerships in other firms (*NSeat*), financial experts on BOC (*BoCexpert*), financial literates on BOC (*BoCComp*) and BOC leadership (*BoCLeader*). Four control variables are also included. First, as the proxy statement (Dechow, Sloan & Sweeney 1996) is not publicly available in Indonesia, a firm's financial requirement is measured by debt ratio (*debt*) and the

firm's performance (*ROA*). Second, ownership concentration (*ownerblock*) is used to control ownership structure (Chen et al. 2006). Lastly, a total asset (*size*) is used to control the effect of company size (Siregar & Utama 2008).

$$LAI = \alpha_0 + \alpha_1unrelated_i + \alpha_2ownerBoC_i + \alpha_3blockingBoC_i + \alpha_4NSeat_i + \alpha_5BoCexpert_i + \alpha_6BoCLeadership_i + \alpha_7ownerblock_i + \alpha_8debt_i + \alpha_9ROA_i + \alpha_{10}size_i + \varepsilon_i \quad (PM1)$$

In the PM2 model, this study tests the relation between audit committee dimensions and the LAI. It investigates audit size (*size*), proportion of independent members (*unrelatedaudit*), committee leadership (*auditleader*), presence of financial experts (*auditexpert*) and financial literates (*auditcomp*) on the committee. The control variable remains same.

$$LAI = \alpha_0 + \alpha_1unrelatedaudit_i + \alpha_2auditleader_i + \alpha_3auditexpert_i + \alpha_4auditcomp_i + \alpha_5ownerblock_i + \alpha_6debt_i + \alpha_7ROA_i + \alpha_8size_i + \varepsilon_i \quad (PM2)$$

The PM3 model examines the board of directors or the board of management characteristic related to LAI. According to NCG (2006) the attributes of effective board of directors are number of executive directors (*size*), professional competence (number of directors with financial literacy [*directorcomp*]), integrity (*CEO tenure* and *executive ownership*) and existing internal control taskforce responsible for the board of directors (*ICFR*). Executive compensation is another important determinant. The control variable remains the same.

$$LAI = \alpha_0 + \alpha_1size_i + \alpha_2directorcomp_i + \alpha_3CEOtenure_i + \alpha_4executiveownership_i + \alpha_5ICFR_i + \alpha_6compensation_i + \alpha_7ownerblock_i + \alpha_8debt_i + \alpha_9ROA_i + \alpha_{10}size_i + \varepsilon_i \quad (PM3)$$

The last partial model (PM4) investigates the relation between auditor quality and LAI. It examines auditor reputation, change of auditor and auditor tenure toward likelihood of LAI. Four other control variables are included.

$$LAI = \alpha_0 + \alpha_1big4_i + \alpha_2auditchange_i + \alpha_3audittenure_i + \alpha_4ownerblock_i + \alpha_5debt_i + \alpha_6ROA_i + \alpha_7size_i + \varepsilon_i \quad (PM4)$$

Moreover, this study does not only use partial models individually to examine the impact of a single governance mechanism on LAI, but also a full model (FM) to examine whether governance mechanisms work as a system. FM1 examines whether BOC, audit committee, BOD and auditor quality affect LAI. Concerning Indonesian listed companies, the previous four control variables are still needed. Then in FM2 is introduced the interaction term of the presence of independent commissioners on the audit committee (*unrelatedaudit*) and the assigning of Big Four auditors (*Big4*). FM2 is used to confirm the collaboration between audit committee and reputable external auditor as a prominent mechanism in preventing LAI.

$$LAI = \alpha_0 + \alpha_1 BOC\_score_i + \alpha_2 audit\_score_i + \alpha_3 BOD\_score_i + \alpha_4 auditor\_score_i + \alpha_5 ownerblock_i + \alpha_6 debt_i + \alpha_7 ROA_i + \alpha_8 size_i + \varepsilon_i \quad (FM1)$$

$$LAI = \alpha_0 + \alpha_1 BOC\_score_i + \alpha_2 audit\_score_i + \alpha_3 BOD\_score_i + \alpha_4 auditor\_score_i + \alpha_5 unrelatedaudit*big4_i + \alpha_6 wnerblock_i + \alpha_7 debt_i + \alpha_8 ROA_i + \alpha_9 size_i + \varepsilon_i \quad (FM2)$$

Specifically in two-tier circumstances, FM3 proposes interaction between BOC and audit committee to ensure vigilant supervision to avoid misstatement in financial reporting. Finally, FM4 is used to detect the collaboration between audit committee and external auditor. The same control variables are proposed.

$$LAI = \alpha_0 + \alpha_1 BOC\_score_i + \alpha_2 audit\_score_i + \alpha_3 BOD\_score_i + \alpha_4 auditor\_score_i + \alpha_5 (BOC\_score*audit\_score)_i + \alpha_5 ownerblock_i + \alpha_6 debt_i + \alpha_7 ROA_i + \alpha_8 size_i + \varepsilon_i \quad (FM3)$$

$$LAI = \alpha_0 + \alpha_1 BOC\_score_i + \alpha_2 audit\_score_i + \alpha_3 BOD\_score_i + \alpha_4 auditor\_score_i + \alpha_5 (audit\_score*auditor\_score)_i + \alpha_5 ownerblock_i + \alpha_6 debt_i + \alpha_7 ROA_i + \alpha_8 size_i + \varepsilon_i \quad (FM4)$$

Table 5.3 provides the summary of variables definition.

## 5.8 Summary

This chapter explains the research design and methods used to test the hypotheses in order to answer this study's research questions. The research design and methods issues discussed are: (i) justification of the research method; (ii) sample selection and procedures; (iii) sample description; (iv) matching procedure; (v) research variables;

and (vi) empirical analysis methods. The next chapter provide the detailed results and the findings discussion.

**Table 5.3 Summary of variables definition**

Variables	Description	Expected sign
<b>Dependent variable</b>		
Sanction level of accounting irregularities (LAI)	Measured by the level of sanction imposed by BAPEPAM-LK. Equal 1 for admonition letter, 2 for fine and 3 for law enforcement after the discovery of accounting irregularities. Equal 0 for each matching sample.	
<b>Independent variables</b>		
<i>Board of commissioners (BOC)</i>		
BOCSize	Size of board of commissioners	?
Unrelated	Percentage of unrelated commissioners	–
OwnerBOC	Percentage of shares held by commissioners	?
BlockingBOC	Number of non-affiliated block holders on BOC	–
NSeat	Number of commissionerships in other firms	+
BOCexpert	Number of financial/accounting (F/A) expert on BOC	–
BOCComp	Number of members with some knowledge of F/A on BOC	–
BOCLeader	Dummy variable, equal to 0 if BoC is led by related commissioner and 1 otherwise	?
BOC_score	3 when president of BOC is not related, percentage of unrelated > 50% and at least 1 financial expert present on BOC; 1 when president of BOC is related, percentage of unrelated is < 50%, absence of financial expert; and 2 in all cases (developed from Smaili & Labelle 2009).	–
<i>Audit committee</i>		
AuditSize	Audit committee size	–
Unrelatedaudit	Percentage of unrelated members	–
Auditexpert	Number of F/A expert on the committee	–
Auditcomp	Number of committee members with knowledge of F/A	–
Auditleader	Dummy variable, equal to 1 if audit committee is led by F/A expert or financially competent commissioner, 0 otherwise	–
Audit_score	3 if leader is financial expert and percentage of member is >66% financial expert and financial competence; 1 if leader is non-financial expert and absence of financial expert; and 2 in other cases (developed from Smaili & Labelle 2009).	–
<i>Board of directors (BOD)</i>		
BODsize	Number of executive directors as top management team	?
BODcomp	Number of directors with F/A literacy	+/-
CEOtenure	Number of years CEO held the office	+/-
BODownership	Percentage of shares held by executive directors	–
ICFR	Equal 1 if there is disclosure of sufficient ICFR, 0 otherwise	–
Compensation	Salaries and additional compensation paid to directors	+/-
BOD_score	3 if presence of financially competent director(s) and internal control over financial reporting established; 1 if absence of financially competent director(s) and ICFR not established; and 2 in all other cases (developed from NCG 2006)	?
<i>Auditor Quality</i>		
Big4	Equal 1 if auditor is Big Four affiliated, 0 otherwise	–
Referral	Equal 1 if auditor is same as parent company auditor, 0 otherwise	+/-

Auditorchange	Equal 1 if there was a change of auditor, 0 otherwise	+
Auditortenure	Number of years auditor engaged	?
Opinion	Equal 1 if financial statement with unqualified opinion, 0 in all other cases.	?
Auditor_score	3 if the auditor is part of Big Four and no change of auditor; 1 if the auditor is not Big 4 affiliated and changes prior the incidence; and 2 in other cases (Smaili & Labelle 2009).	–
<i>Control variables</i>		
Ownership		
OwnerBlock	Percentage of shares held by block holders (>5% ownership)	–
Financial Needs:		
Debt	Leverage ratio (total debts/total equities)	+
ROA	Return on assets (net income/total assets)	?
Size	Firm size by total assets	–

Source: Adapted from Smaili and Labelle (2009) and NCG (2006)

## **CHAPTER 6 RESULTS AND DISCUSSION**

### **6.1 Introduction**

This chapter reports and discusses the findings of the study. In the first section, the characteristics of firms committing accounting irregularities are described. In the second section, the study compares firms with accounting irregularities with those not doing so, using a mean difference analysis to compare the two groups. The next third section provides correlations among research variables and tests of parallel lines assumptions. The fourth and fifth sections examine the hypotheses and discuss the outcomes of the ordinal logistic regression using the order of the hypotheses mentioned in chapter 4. The statistical analysis is used to determine the effectiveness of individual governance dimensions (partial models) and governance as a system (full models). The last section reports the results of a number of sensitivity tests to ensure the robustness of previous analyses.

### **6.2 Accounting irregularities in financial statements**

During the period 2000–2009, BAPEPAM-LK has named 99 firms with accounting irregularities in the annual reports, but the current analysis includes only 78 of them due to unavailability of firms' annual reports (see Table 5.1). The proxy of accounting irregularities uses cases involving issuers and public-listed companies disclosures might be: (1) violation against provisions of affiliated and conflict of interest transactions; (2) material transactions; (3) particular shareholders disclosures; (4) material information that must be disclosed to the public; (5) financial misstatements; and (6) improper use of funds raised from IPO (BAPEPAM-LK 2000-2009).

It is difficult to construct a valid measurement for the incidences of accounting irregularities, since these actions are unobservable. In this research area, most of empirical studies infer accounting irregularities from observing extraordinary cases in which manipulation is likely to have occurred (e.g. regulatory or legal action and incidences of financial misstatements). In Indonesia, this information may be traced in

the law enforcement section of each Indonesian market authority (BAPEPAM-LK) annual report. As reported earlier (see chapter 2), during the last decade BAPEPAM-LK has fined annually more than 170 listed firms and investigated more than 40 firms due to serious offences (see Appendix B). However, only issuers' details with extraordinary cases have been disclosed in BAPEPAM-LK annual reports and BAPEPAM-LK keeps confidentially for most cases. One concern with this proxy is that it incorrectly classifies firms with financial misstatements but that are not identified for their accounting irregularities. This potential for misclassification is regarded as a limitation of this study, as well as of previous studies in this area (see, for example, Armstrong, Jagolinzer & Larcker 2010).

Prior to comparison with the control group, the 78 listed firms with accounting irregularities are reviewed and classified according to industry, methods, perpetrators, motivation of the perpetrators and the sanctions imposed. The summary of cases reveals some aspects by using some perspective of attribution theory and/or fraud triangle and fraud diamond (see section 2.4.2). The sample is distributed across wide variety of Indonesian industries (refer Table 5.2). This study has created Table 6.1–4 to present separately the summary for the methods, perpetrators, their motivation and the outcomes for perpetrators.

Table 6.1 shows the most common type of accounting irregularities to be the misapplication of accounting information. Different methods of misapplication were used, the most frequent being intentional omission to disclose material information, used in 29.49% of cases. Another frequent *modus operandi* is financial transaction with conflict of interest. This method accounts for 20.51% of cases and constitutes an inherent risk of firms under a business group. Other methods used include: unauthorized material transactions; misclassifying accounts and presentations; and failing to record a significant amount of liabilities.

The high level of misapplication of accounting information suggests that there are serious problems of disclosure compliance among listed companies. Even though the disclosure index is about 92.65% of mandatory disclosures (Subroto 2003), a

comparison study reveals that Indonesian listed firms' transparency index based on Standard and Poor's score is ranked as low as the 22nd of 25 countries studied (Bushee 2004).

**Table 6.1 Methods used by firms with accounting irregularities**

Methods	Number of cases	Percentage of 78 cases studied
<b>Misapplication of accounting information</b>		
Failing to disclose material information	23	29.49%
Conflict of interest transactions	16	20.51%
Unapproved material transactions	11	14.10%
Misclassifying accounts and presentation	8	10.26%
Failing to record liabilities	4	5.13%
<b>Manipulation and falsification</b>		
Incorrect consolidated figures	8	10.26%
Incorrect assets valuation	7	8.97%
Fictitious revenue	4	5.13%
ESOP and compensation	2	2.56%
<b>Others</b>	<b>17</b>	<b>21.79%</b>

Furthermore, firms with severe cases commonly engage in manipulation or falsification of accounting records from which financial statements are prepared. Official reports and press release documents that use the incorrect consolidated figures, forging assets valuation, inflating revenues and misleading ESOP plans are among the methods used. Cases in asset-intensive firms such as PT. Indofarma, Tbk (BAPEPAM-LK 2004) manipulated inventories accounts, while revenue-rich firms such as PT. Katarina Utama, Tbk falsified revenues in 2009. Other types of methods used included, for instance the case of a non-prudential banking practice committed by the senior management of PT. Bank Century, Tbk in 2008. In some cases, more than one method was used by perpetrators; therefore the total number of cases in Table 6.1 is larger than the number of cases studied.

It can be seen from the data in Table 6.2 that corporations are responsible for the incidence of accounting irregularities in most cases (66.67% of total cases). According to the Company Act 2007 (article 13), the company shall accept or take over all rights and obligations arising from the legal acts conducted by the founders for the interest of



a company. To some extent, this increases moral hazard, where the investigation could end up with an indictment of a corporation rather than perpetrators personally. This may reduce the deterrent effect of law enforcement actions. Therefore, it is important that directors' certification on financial statements sends a strong message of the possibility of personal liability, and not always as a fiduciary role on behalf of the company. The following reports and discusses the indictment of both internal and external parties.

**Table 6.2 Perpetrators at firms with accounting irregularities**

Perpetrator	Number of cases	Percentage of 78 cases studied
<b>Corporation</b>	<b>52</b>	<b>66.67%</b>
<b>Internal perpetrators</b>		
President director	24	30.77%
Commissioners	11	14.10%
Other senior management	11	14.10%
Chief financial officer	9	11.54%
Audit committee member	2	2.56%
Other employees	1	1.28%
Senior accounting staff	0	0.00%
Junior accounting staff	0	0.00%
<b>External perpetrators</b>		
Auditors	6	7.69%
Other outsiders	7	8.97%

Senior management and commissioners are the internal parties who are the most responsible for the accounting irregularities. As shown in Table 6.2, president directors (CEO) account for 30.77% of 78 cases. Others responsible include marketing directors, operational directors and finance directors. The involvement of those senior management are due to their ability to override internal controls and lead lower staff to conceal and commit various types of accounting malfeasance. Commissioners and audit committees who are responsible for overseeing firms' financial reporting were indicted due to negligence and/or underperformance.

Accounting staff were hardly ever involved 'as perpetrators' in a case of accounting irregularities. This confirms that accounting irregularities are management problems, rather than employee issues.

As the preparation of financial statements also involves external parties, errors or frauds may also be triggered by external perpetrators. Lawsuits against auditors are more about their negligence. This study finds 7.69% of total cases that involved auditors. They were sued for being negligent in performing their duty as suggested by Indonesian auditing standards. On one occasion, the auditor did not report directly to BAPEPAM-LK regarding any finding of breaching the Capital Market Law and other related rules. Other outsiders have also been found as the cause of these reporting incidences, including legal advisers.

**Table 6.3 Motivation for accounting irregularities**

Motivations	Number of cases	Percentage of 78 cases studied
<b>Influence stock market</b>		
To support new strategy	18	23.08%
Personal gain	15	19.23%
Inflate stock price	9	11.54%
Success of public offerings	7	8.97%
<b>Others</b>		
Financially distressed	13	16.67%
Others	18	23.08%

As shown in Table 6.3, influencing stock prices to support a new strategy or for personal gain were the most common motives for accounting irregularities. In cases of supporting a business strategy (23.08% of cases), the perpetrators took their actions through avoiding removal from directorship and protecting their reputation. However, in 19.23% of cases personal gain was the sole explanation for publishing financial statements with error or fraud. This study also documents that 11.54% of cases engaged in accounting irregularities to inflate the stock price afterwards. When an insider perpetrator sells shares while the firm's bottom lines are misstated, they could potentially commit either accounting fraud or insider trading. Moreover, in some cases the motivation is to achieve success for the IPO.

**Table 6.4 Outcomes for perpetrators**

<b>Outcome</b>	<b>Number of cases</b>	<b>Percentage of 78 cases studied</b>
<b>Company</b>		
Company receives monetary penalties	47	60.26%
less IDR100 million	6	7.69%
less IDR1 billion	5	6.41%
more than IDR5 billion	1	1.28%
New commissioner employed	11	14.10%
New audit committee member employed	11	14.10%
Company prosecuted by BAPEPAM-LK	9	11.54%
Company asked to restate financial statement	7	8.97%
New management employed as result of case	5	6.41%
Company share trading suspension	5	6.41%
Company closed but re-formed under new name	5	6.41%
Company delisted from IDX	3	3.85%
Company receives written admonition	1	1.28%
Company bankrupts due to the case	0	0.00%
Others	2	2.56%
<b>Perpetrators</b>		
Perpetrators fined	16	20.51%
less IDR100 million	2	2.56%
less IDR1 billion	6	7.69%
more than IDR5 billion	3	3.85%
Perpetrators receive written admonition	11	14.10%
Perpetrators prosecuted by BAPEPAM-LK	8	10.26%
Perpetrators receive prison sentence	2	2.56%
Perpetrators listed as ‘wanted’	2	2.56%
Others	1	1.28%
<b>Auditors</b>		
Auditors are held responsibility for the case:	5	6.41%
Fined	2	2.56%
Licence suspension	2	2.56%
Licence revocation	0	0.00%
Written admonition	1	1.28%
New auditor employed for restatement	4	5.13%
Auditor reports to BAPEPAM-LK	1	1.28%
Auditor sues company for concealing	0	0.00%
Other professional disciplinary actions	0	0.00%
<b>Shareholders</b>		
Sue company, auditors and perpetrators for losses	1	1.28%

Source: Summary of firms with accounting irregularities from 2000–2009.

Table 6.3 also provides strong evidence that firms might engage in accounting irregularities due to being financially distressed. Among the cases studied, there were 16.67% of total cases subject to disciplinary actions from BAPEPAM-LK because they were experiencing financial difficulties. This is consistent with Elloumi and Gueyie’s

study (2001) and suggests that when a firm's business deteriorates to the point where it cannot meet its financial obligations, the firm is said to have entered the state of financial distress. The first signals of distress are usually violations of debt covenants coupled with bad practices of corporate governance. In some cases, these firms with financial distress were delisted from the stock market prior to disciplinary actions. Other motivations were not specified in detail by BAPEPAM-LK or other reliable sources.

Outcome for the perpetrators are presented in Table 6.4. It is apparent from this table that mostly the outcomes of law enforcement actions were a company indictment and very few outcomes for personal involvement. It is difficult to explain this result, but it might be related to the nature of the Indonesian economy and less effective law enforcement actions. As an emerging market, the country might be politically trying to retain capital as much as possible. The other reason is the regulatory body, which is BAPEPAM-LK, may not only perform as a watchdog but also has a coaching function for capital market participants, including listed companies. Therefore, the findings also support the establishment of a Financial Services Authority (or OJK in Bahasa Indonesia) by 2013 for a good model for establishing a strong, independent financial services regulator across banking and non-banking institutions in Indonesia (see section 3.6.2).

Regarding organisational factors related to the incidences of accounting irregularities, comprehensive quantitative analyses are used: (i) to differentiate between this sample of firms and the compliant counterparts; and (ii) to determine the effect of corporate governance on the seriousness of those with accounting irregularities in Indonesia. The following presents and discusses the analyses in order to explore the proposed hypotheses.

### **6.3 Descriptive statistics and univariate analyses**

To distinguish between these two groups, descriptive statistics and univariate analysis of variables for BOCs, audit committees, BODs and auditors' quality for fraudulent firms and compliant companies are provided, to reveal how corporate governance mechanisms work in a two-tier board system. Here the group mean difference is

important in understanding how the two-tier system works. Table 6.5 reports the minimum, maximum, mean and results of t-test for differences of means.

### **6.3.1 Board of commissioners characteristics**

Panel 1 of Table 6.5 on the page 139 presents the findings related to H1 (see Figure 4.1) showing that the BOC membership of compliant firms has statistically fewer members than their sanctioned counterparts (t-test =  $-1.522$ ;  $\alpha = 5\%$ ). In addition, the average proportion of unrelated members in compliant firms is 39.1%, whereas sanctioned firms had 36.7%. However, the proportion for both groups shows no difference. BOC ownership is higher in sanctioned firms, whereas the existence of block holders is higher in compliant firms. However, the number of seats showing commissioners' good reputation does not show any statistical difference. Moreover, the BOC's financial expertise among firms that committed accounting irregularities are significantly smaller (t-test =  $2.279$ ;  $\alpha = 5\%$ ) than those that comply with disclosure rules. This means that financially expert members are more likely to supervise their management team in order to avoid accounting irregularities. The panel data in Table 6.5 shows that listed firms appointed more financially literate members on their BOCs than those who have designation as qualified experts. Firm being headed by both independent and affiliate members showed no statistical difference.

On average, the BOC score of compliant firms (2.26 out of 3) is higher than those with accounting irregularities (2 out of 3). The univariate analysis indicates that the score of the two groups of firms differs significantly ( $P < 0.01$ ) between the compliant firms and those not so. This result is consistent with H1, which hypothesises that BOC effectiveness is negatively associated with the gravity of accounting irregularities incidences.

### **6.3.2 Audit committee characteristics**

In relation to H2 regarding audit committee effectiveness (Figure 4.1), BAPEPAM-LK and IDX require listed companies to appoint audit committees that consist of at least independent commissioner (as chairman) and two outside members, one of whom with an accounting or finance degree. As implementation of good corporate governance

practice, the IDX has required listed companies to establish audit committees since 2001. However, compliance with this rule was low until the promulgation of BAPEPAM-LK regulation IX.I.5 in 2004 where audit committee establishment is compulsory for listing requirements. Therefore after this BAPEPAM-LK rule came into effect, audit committee effectiveness is not only determined by establishment and composition, but also beyond its existence including the presence of audit experts and financially literate members. The following univariate analysis shows the profile of Indonesian firms' audit committees.

Panel 2 of Table 6.5 shows that, on average, audit committees consist of three members. In this study, the proportion of unrelated members of both sample groups is statistically the same. In addition, firms that commit accounting irregularities have only 17% of audit committee members who are considered expert, whereas the control firms have 37% expert members. Financially literate members of audit committees in both cases are the same. This preliminary finding is consistent with those of Smaili and Labelle (2009) and Farber (2005) who have found that appointing expert members can be more effective in deterring accounting irregularities, due to the pressure of maintaining their reputations as diligent in assisting BOCs.

On average, the AUDIT score of compliant firms (1.94 out of 3) is higher than those with accounting irregularities (1.58 out of 3). The univariate analysis indicates that the score of the two group of firms differs significantly ( $P < 0.01$ ) between the compliant firms and those not so. This result is consistent with H2, which hypothesises that audit committees' effectiveness is negatively associated with the gravity of accounting irregularities incidences.

### **6.3.3 Board of directors characteristics**

As this study attempts to contribute to the two-tier board system, this section shows the characteristics of firms' top management teams. As mentioned in earlier chapters, Indonesia also calls the top management board of directors, which consists of executive directors only. Findings reported in Panel 3 of Table 6.5 indicate that CEO tenure and

management attention towards internal control over financial reporting are both dimensions that lower accounting irregularities.

The mean value for the board of directors' size is 4.40 for companies with accounting irregularities and 4.48 for compliant firms. These values represent that on average the number of executive directors as members of top management is about four to five directors. They consist of a president director (CEO) and additional operational directors. The difference is not statistically significant ( $p > 0.10$ ).

On average, 23% of executive directors for companies with accounting irregularities possess knowledge of financial matters (BOD competence), while 32% of BOD members of companies with no accounting irregularities have financial competence. However, the univariate analysis indicates that the percentage of BOD members with financial competence is not statistically different.

The mean of CEO tenure of companies with accounting irregularities is 5.33 years, which is statistically shorter than those not so (7.26 years). The benefit of having a long-tenured CEO is consistent with the "upper echelons perspective" proposed by Hambrick and Mason (1984) where for a company in a stable environment, years for service are positively associated with growth and profitability. These dimensions are statistically different at p-value 5%.

Only 28% of companies with accounting irregularities have reported the importance of their internal control function (ICFR), while more than 90% of firms with no accounting irregularities have established internal control over financial reporting. The difference is statistically significant ( $p < 0.05$ ).

The mean value of executive directors' shareholding is 0.018 (0.666 maximum) for firms with accounting irregularities and 0.014 (0.510 maximum) for non-accounting irregularities firms. These data suggest that the average cumulative ownership in the company held by insider executive directors is less than 2 percent for both groups. There are also interesting figures that some firms have executive directors' shareholding

up to a majority 66 percent. The finding shows that directors' ownership is not statistically different for both sample groups as far as this dimension is used to align management and shareholders' interests (Agrawal & Chadha 2005; Eisenhardt 1989).

In addition to the above dimension, on average, BOD members of firms with accounting irregularities receive 2.4 percent (26% maximum) of total revenue as compensation, while it is 2.5 percent (33% maximum) of compensation of firms with no accounting irregularities. The dimension of BOD compensation shows no difference; according to agency theory, this could be an anomaly. The preliminary finding is consistent with Wilopo (2006) who has found that directors' compensation is not a significant predictor for financial fraud within Indonesian context.

On average, the BOD score of compliant firms (2.380 out of 3) is higher than those with accounting irregularities (1.6 out of 3). The univariate analysis indicates that the score of the two groups of firms differs significantly ( $p\text{-value} < 0.01$ ). This result is consistent with H3, which hypothesises the BODs' or top management teams' effectiveness is negatively associated with the gravity of accounting irregularities incidences.

#### **6.3.4 Auditor**

Panel 4 of Figure 6.5 shows an important finding of univariate analysis, that a situation where a changing auditor is caused by referral constitutes a lower level of accounting irregularities ( $p\text{-value} < 10\%$ ). This might suggest that auditor appointment with block holders' agreement could be a signal of a high degree of auditor independence. This is consistent with Branson and Breesch's study (2004) that found that referral behaviour is an important and decisive determinant of auditor choice when a subsidiary–parent relationship exists.

On average, 40% of the firms that committed accounting irregularities are audited by Big Four auditors as compared to 50% in the case of control companies; however, the difference is not statistically significant. Big Four auditors do not represent their own companies, but instead are affiliated with local audit firms. There are: first, Ernst & Young affiliated with Purwantono Sarwoko & Sandjaja; second, Deloitte Touche



Tohmatsu affiliated with Osman Bing Satrio & Rekan; third, KPMG affiliated with Sidharta & Widjaja; and forth, PriceWaterhouseCoopers affiliated with Hadi Sutanta & Rekan. Contrary to expectations from literature (see, for example, DeAngelo, L 1981), no differences were found and the analysis suggests that big audit firms do not guarantee better audit quality than small audit firms.

Further analysis showed that a large proportion (40%) of firms that commit accounting irregularities have changed their auditor in the period before BAPEPAM-LK detection (see Table 6.5). In addition, the control firms seem to have longer auditor tenure than those that commit accounting irregularities. However, change of auditors and their tenure are not statistically significant.

Furthermore, the mean value of firms with ‘unqualified audit opinion’ is 49% of those subject to BAPEPAM-LK investigation and 77% of form with no accounting irregularities. The most striking result to emerge from the data is that those who comply with the reporting regulation have a higher level of financial reporting credibility ( $t\text{-test}=3.786; \alpha=5\%$ ).

On average, the AUDITOR score of compliant firms (2.220 out of 3) is higher than those with accounting irregularities (2.030 out of 3). The univariate analysis indicates that the score of the two groups of firms does not differ significantly ( $p\text{-value}>0.10$ ). This preliminarily result does not support H4, which hypothesises that auditor quality is negatively associated with the gravity of accounting irregularities incidences. A further regression analysis is used to determine the association between audit quality and the gravity of the incidences of accounting irregularities.

**Table 6.5 Statistics descriptive of independent variables  
for a sample of 78 firms indicted at various LAI matched with 78 firms with no accounting Irregularities**

Variables	with acc't irregularities			with no accounting irregularities			t-test	p-value
	Min	Max	Mean	Min	Max	Mean		
<i>Panel 1: Board of commissioners</i>								
BOC SIZE	2	12	4.370	2	8	3.920	−1.522	0.015*
UNRELATED	0.000	1.000	0.391	0.000	0.750	0.367	−1.058	0.292
OWNER BOC	0.000	0.976	0.037	0.000	0.546	0.017	−1.068	0.287
BLOCKING BOC	0	12	1.760	0	5	1.884	0.459	0.647
NSEAT	0	24	4.310	0	30	3.833	−0.684	0.495
BOC EXPERT	0	1	0.170	0	3	0.358	2.279	0.024*
BOC COMP	0	5	1.030	0	3	1.076	0.380	0.705
LEADERSHIP	0	1	0.015	0	1	0.076	−1.505	0.134
BOC Score	1	3	2.000	1	3	2.260	2.786	0.006*
<i>Panel 2: Audit committee</i>								
AUDIT SIZE	0	7	2.420	0	6	2.740	1.638	0.100**
UNRELATED AUDIT	0.000	0.670	0.273	0.000	0.670	0.294	0.892	0.292
AUDIT LEADER	0	1	0.270	0	1	0.410	1.868	0.287
AUDIT EXPERT	0	2	0.170	0	2	0.371	2.612	0.010*
AUDIT COMP	0	2	0.870	0	2	0.974	1.075	0.284
AUDIT Score	1	3	1.58	1	3	1.94	2.543	0.012*
<i>Panel 3: Board of directors</i>								
BOD SIZE	2	10	4.400	2	8	4.483	−0.462	0.645
BOD COMPETENCE	0	1	0.230	0	1	1.327	1.660	0.099**
CEO TENURE	0	27	5.330	0	34	7.258	2.194	0.030*
BOD OWNERSHIP	0.000	0.666	0.018	0.000	0.510	0.014	−0.715	0.475
ICFR	0	1	0.280	0	1	0.914	8.899	0.000*
COMPENSATION	0.000	0.260	0.024	0.000	0.330	0.025	0.223	0.824
BOD Score	1	3	1.600	1	3	2.380	7.087	0.000*

*(to be continued)*

**Table 6.5 (continued)**

<b><i>Panel 4: Auditor quality</i></b>								
BIG4	0	1	0.400	0	1	0.500	1.286	0.200
REFERRAL	0	1	0.080	0	1	0.230	2.708	0.008*
AUDIT CHANGE	0	1	0.410	0	1	0.280	−1.687	0.094
TENURE	1	5	1.870	1	5	2.010	0.931	0.353
OPINION	0	1	0.490	0	1	0.770	3.786	0.000*
AUDITOR Score	1	3	2.030	1	3	2.220	1.614	0.109
<b><i>Panel 5: Control variables</i></b>								
OWNER BLOCK	0.057	0.976	0.653	0.100	0.964	0.685	1.141	0.255
DEBT EQUITY	−31.819	27.225	1.323	−30.073	85.445	3.526	1.392	0.166
ROA	−0.960	0.451	−0.029	−0.568	0.306	0.009	1.444	0.151
LN SIZE	22.669	31.610	27.309	23.208	31.636	27.254	−0.121	0.904
SIZE CHANGE	−0.541	20.982	0.549	−0.846	1.764	0.112	1.621	0.107

\* and \*\* statistically significant at 5% and 10% of confidence level, respectively.

### **6.3.5 Control variables**

#### **6.3.5.1 Block Holders**

The mean (maximum) value for block holders is 0.653 (0.976) for firms with accounting irregularities and 0.685 (0.964) for firms with no accounting irregularities. The data suggest that, on average, 65.3% shares are held by block holders of firms that commit various accounting irregularities, while 68.5% shareholding belongs to block holders for firms with no accounting irregularities. The difference in block holders ownership is not statistically significant (p-value>0.10).

#### **6.3.5.2 Financial need**

##### *Leverage*

On average, firms with accounting irregularities account for 132 % debt-to-equity ratio, while firms with no accounting irregularities have 139% debt-to-equity ratio. The difference in leverage ratio of both categories is not statistically significant (p-value<0.10). This result indicates that debt problems do not lead automatically to defrauding of financial statement users. As the majority of the sample consists of banking and finance firms with highly regulated structures, an authoritative supervision function (for example the Central Bank of Indonesia) could strengthen the firms' corporate governance systems in ensuring the credibility of financial reporting.

##### *Return on assets*

As in Carcello and Neal (2003), this study has also noticed that a majority of firms with accounting irregularities have negative performance. The mean (maximum) value for return on assets is -0.029 (0.451) for firms with accounting irregularities and 0.009 (0.306) for non-accounting irregularities firms. Fraudulent firms seem to have a more volatile net income than their control firm counterparts. The difference in the extent of their return on assets is not statistically significant (p-value<0.10).

#### **6.3.5.3 Firm size**

The average size of firms with accounting irregularities is 27.309 and 27.254 for those firms with no accounting irregularities. Since firms' size is logarithm natural transformed, the average of anti-logarithm natural shows that firms' total assets is IDR724,682,887,816.26 for firms that commit accounting irregularities and IDR 685,901,590.294.13 for their compliant counterparts.

The mean difference analysis does not show a significant difference between both categories at  $p\text{-value} < 10\%$ . Further analysis reveals that, on average, there are 0.549 increases in assets for firms with accounting irregularities and 0.112 increasing of assets for the compliant counterparts. This dimension is statistically significant at  $p\text{-value} < 10\%$ .

#### **6.4 Correlation and test of parallel lines assumption**

Before turning to the main objective of this study, which is to determine whether the sanction level of accounting irregularities is negatively associated with corporate governance systems effectiveness, this study will (1) conduct the correlation test and (2) check the parallel lines assumption as a condition of further ordinal regression analysis. As co-linearity is not an issue with ordinal regression, a correlation matrix is provided to specify if there are highly significant relationships between the LAI and research variables. By ordinal regression's assumption of parallel lines, the location parameter for a given LAI is the slope of that research variable for any level of threshold using the sanction level of accounting irregularities incidences. Therefore, further analyses require that location parameters (slope coefficients) are the same across response categories.

Table 6.6 presents the correlation matrixes between research variables. There are some significant and high correlations among the research variables. Some of the significant relationships are expected, since there are multiple measures for some theoretical dimensions. A noteworthy correlation is between LAI and BOC expertise, LAI and number of audit committee members, LAI and internal control function, and LAI and some auditor dimensions. The following paragraphs explain the details of the correlations.

**Table 6.6 Pearson correlation matrices between LAI and research variables**

<b>Variables</b>	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>	<b>(5)</b>	<b>(6)</b>	<b>(7)</b>	<b>(8)</b>	<b>(9)</b>	<b>(10)</b>	<b>(11)</b>	<b>(12)</b>	<b>(13)</b>	<b>(14)</b>	<b>(15)</b>
LAI	1														
Panel 1															
BOC SIZE	0.189	1													
UNRELATED	0.013	−0.024	1												
OWNER BOC	0.083	−0.114	0.207 <sup>b</sup>	1											
BLOCKING BOC	0.082	0.648 <sup>b</sup>	−0.406 <sup>b</sup>	−0.090	1										
NSEAT	0.121	0.658 <sup>b</sup>	−161 <sup>a</sup>	−0.004	0.478 <sup>b</sup>	1									
BOC EXPERT	−0.175 <sup>a</sup>	0.130	0.145	−0.026	0.051	0.073	1								
BOC COMP	−0.044	0.244 <sup>b</sup>	0.223 <sup>b</sup>	0.023	−0.086	0.173 <sup>a</sup>	0.056	1							
LEADERSHIP	0.125	0.134	0.266 <sup>b</sup>	−0.084	0.072	0.008	−0.028	−0.028	1						
BOC Score	−0.247 <sup>b</sup>	0.107	0.350 <sup>b</sup>	−0.012	−0.097	0.042	0.715 <sup>b</sup>	0.326 <sup>b</sup>	0.058	1					
Panel 2															
AUDIT SIZE	−0.164 <sup>a</sup>	0.087	0.404 <sup>b</sup>	0.045	−0.289 <sup>b</sup>	−0.105	0.247 <sup>b</sup>	0.314 <sup>b</sup>	−0.008	0.298 <sup>b</sup>	1				
UNRELATED AUDIT	−0.085	0.040	0.378 <sup>b</sup>	0.041	−0.303	−0.078	0.239 <sup>b</sup>	0.296 <sup>b</sup>	−0.053	0.305 <sup>b</sup>	0.771 <sup>b</sup>	1			
AUDIT LEADER	−0.120	0.156	0.099	0.008	0.090	0.095	0.434 <sup>b</sup>	0.247 <sup>b</sup>	−0.047	0.398 <sup>b</sup>	0.299 <sup>b</sup>	0.305 <sup>b</sup>	1		
AUDIT EXPERT	−0.218	0.159 <sup>a</sup>	0.184 <sup>a</sup>	−0.051	0.071	0.060	0.579 <sup>b</sup>	0.090	0.046	0.475 <sup>b</sup>	0.226 <sup>b</sup>	0.276 <sup>b</sup>	0.400 <sup>b</sup>	1	
AUDIT COMP	−0.126	0.081	0.203 <sup>a</sup>	0.018	−0.175 <sup>a</sup>	0.102	0.084	0.265 <sup>b</sup>	−0.088	0.176 <sup>a</sup>	0.634 <sup>b</sup>	0.551 <sup>b</sup>	0.275 <sup>b</sup>	0.027	1

a. Correlation is significant at the 0.05 level (2-tailed).

b. Correlation is significant at the 0.01 level (2-tailed).

**Table 6.6 Pearson correlation matrices between LAI and research variables (continued)**

<b>Variables</b>	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>	<b>(5)</b>	<b>(6)</b>	<b>(7)</b>	<b>(8)</b>	<b>(9)</b>	<b>(10)</b>	<b>(11)</b>	<b>(12)</b>	<b>(13)</b>	<b>(14)</b>	<b>(15)</b>
AUDIT Score	−0.205 <sup>a</sup>	0.170 <sup>a</sup>	0.213 <sup>b</sup>	−0.020	0.013	0.059	0.458 <sup>b</sup>	0.239 <sup>b</sup>	−0.014	0.452 <sup>b</sup>	0.399 <sup>b</sup>	0.392 <sup>b</sup>	0.710 <sup>b</sup>	0.709 <sup>b</sup>	0.399 <sup>b</sup>
Panel 3															
BOD SIZE	0.068	0.379 <sup>b</sup>	0.225 <sup>b</sup>	0.053	0.154	0.130	0.091	0.085	0.100	0.153	0.100	0.044	−0.007	0.170 <sup>a</sup>	0.062
BOD COMP	−0.051	0.082	0.275 <sup>b</sup>	0.198 <sup>a</sup>	−0.092	−0.029	0.196 <sup>a</sup>	0.240 <sup>b</sup>	0.139	0.287 <sup>b</sup>	0.231 <sup>b</sup>	0.115	0.135	0.208 <sup>b</sup>	0.103
CEO TENURE	−0.119	0.022	0.140	−0.004	0.009	0.061	0.046	0.054	−0.014	0.052	0.042	0.024	0.048	0.123	0.037
BOD OWNERSHIP	0.101	−0.079	0.039	0.048	−0.106	−0.029	0.196 <sup>a</sup>	−0.049	−0.055	0.042	−0.020	0.300 <sup>b</sup>	−0.032	0.124	0.050
ICFR	−0.498 <sup>b</sup>	−0.022	0.067	0.026	0.007	−0.016	0.234 <sup>b</sup>	0.099	−0.051	0.301 <sup>b</sup>	0.064	0.104	0.267 <sup>b</sup>	0.209 <sup>b</sup>	0.084
COMPENSATION	−0.054	−0.185 <sup>a</sup>	0.023	0.051	−0.176	−0.032	0.219 <sup>a</sup>	−0.027	−0.089	−0.001	0.004	0.055	0.076	0.089	0.091
BOD Score	−0.419 <sup>b</sup>	−0.083	0.120	0.094	−0.118	−0.055	0.218 <sup>b</sup>	0.253 <sup>b</sup>	−0.048	0.307 <sup>b</sup>	0.210 <sup>b</sup>	0.194 <sup>a</sup>	0.263 <sup>b</sup>	0.249 <sup>b</sup>	0.163 <sup>a</sup>
Panel 4															
BIG4	−0.081	0.138	0.028	−0.011	0.279 <sup>b</sup>	0.012	0.208 <sup>b</sup>	0.006	0.078	0.177 <sup>a</sup>	−0.082	−0.084	0.196 <sup>a</sup>	0.211 <sup>b</sup>	−0.122
REFERRAL	−0.172 <sup>a</sup>	0.082	0.207 <sup>b</sup>	−0.100	0.034	−0.056	0.190 <sup>a</sup>	0.165 <sup>a</sup>	−0.043	0.119	0.160 <sup>a</sup>	0.116	0.144	0.198 <sup>a</sup>	0.055
AUDIT CHANGE	0.171 <sup>a</sup>	−0.029	0.078	−0.032	−0.018	−0.024	−0.157	0.036	0.201 <sup>a</sup>	−0.067	−0.017	0.005	−0.067	−0.069	0.003
AUDIT TENURE	−0.139	−0.058	0.077	0.007	−0.144	−0.072	0.107	0.012	−0.148	0.083	0.085	0.055	−0.100	0.006	0.026
OPINION	−0.240 <sup>b</sup>	−0.075	0.153	−0.054	−0.095	−0.034	0.180 <sup>a</sup>	0.000	−0.096	0.259 <sup>b</sup>	0.182 <sup>a</sup>	0.214 <sup>b</sup>	0.076	0.123	0.146
AUDITOR Score	−0.135	0.104	−0.003	0.007	0.186 <sup>a</sup>	0.019	0.226 <sup>b</sup>	0.031	−0.086	0.155	−0.029	−0.056	0.191 <sup>a</sup>	0.188 <sup>a</sup>	−0.095
Panel 5															
OWNER BLOCK	−0.123	0.075	−0.070	−0.077	0.101	0.024	0.076	0.085	−0.003	0.168 <sup>a</sup>	0.017	0.014	0.155	0.003	0.037

a. Correlation is significant at the 0.05 level (2-tailed).

b. Correlation is significant at the 0.01 level (2-tailed).

**Table 6.6 Pearson correlation matrices between LAI and research variables (continued)**

<b>Variables</b>	<b>(16)</b>	<b>(17)</b>	<b>(18)</b>	<b>(19)</b>	<b>(20)</b>	<b>(21)</b>	<b>(22)</b>	<b>(23)</b>	<b>(24)</b>	<b>(25)</b>	<b>(26)</b>	<b>(27)</b>	<b>(28)</b>	<b>(29)</b>	<b>(30)</b>
AUDIT Score	1														
Panel 3 (continued)															
BOD SIZE	0.109	1													
BOD COMP	0.192 <sup>a</sup>	0.435 <sup>b</sup>	1												
CEO TENURE	0.144	0.021	0.157 <sup>a</sup>	1											
BOD OWNERSHIP	0.032	−0.099	−0.057	−0.030	1										
ICFR	0.242 <sup>b</sup>	0.115	0.280 <sup>b</sup>	0.121	0.083	1									
COMPENSATION	0.045	−0.222 <sup>a</sup>	−0.005	−0.154	0.403 <sup>b</sup>	0.029	1								
BOD Score	0.289 <sup>b</sup>	−0.084	0.524 <sup>b</sup>	0.189 <sup>a</sup>	0.056	0.699 <sup>b</sup>	0.152	1							
Panel 4 (continued)															
BIG4	0.130	0.321 <sup>b</sup>	0.234 <sup>b</sup>	0.061	−0.170 <sup>a</sup>	0.132	−0.198 <sup>a</sup>	0.007	1						
REFERRAL	0.235 <sup>b</sup>	0.043	0.086	0.228 <sup>b</sup>	−0.009	0.226 <sup>b</sup>	−0.060	0.251 <sup>b</sup>	0.151	1					
AUDIT CHANGE	−0.058	−0.126	−0.073	−0.102	0.085	−0.104	−0.012	−0.097	−0.142	−0.124	1				
AUDIT TENURE	−0.009	−0.023	0.025	0.151	−0.060	0.084	0.025	0.138	0.014	0.215 <sup>b</sup>	−0.671 <sup>b</sup>	1			
OPINION	0.132	0.032	0.080	0.041	0.040	0.297 <sup>b</sup>	0.034	0.246 <sup>b</sup>	0.054	0.181 <sup>a</sup>	−0.165 <sup>a</sup>	0.164 <sup>a</sup>	1		
AUDITOR Score	0.131	0.306 <sup>b</sup>	0.208 <sup>b</sup>	0.114	−0.173 <sup>a</sup>	0.177 <sup>a</sup>	−0.077	0.089	0.752 <sup>b</sup>	0.216 <sup>b</sup>	−0.715 <sup>b</sup>	0.430 <sup>b</sup>	0.126	1	
Panel 5 (continued)															
OWNER BLOCK	0.121	0.059	0.037	−0.071	−0.098	0.067	−0.170	0.061	0.163 <sup>a</sup>	0.027	−0.003	0.032	−0.099	0.082	1

a. Correlation is significant at the 0.05 level (2-tailed).

b. Correlation is significant at the 0.01 level (2-tailed).



**Table 6.6 Pearson correlation matrices between LAI and research variables (continued)**

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
DEBT EQUITY	−0.065	−0.036	0.219 <sup>b</sup>	0.131	−0.105	−0.050	0.079	0.035	0.209 <sup>b</sup>	0.175 <sup>a</sup>	0.151	0.093	−0.028	0.114	0.097
ROA	−0.140	0.118	0.086	−0.013	0.085	0.025	0.140	0.003	0.143	0.158 <sup>a</sup>	0.179 <sup>a</sup>	0.194 <sup>a</sup>	0.175 <sup>a</sup>	0.139	0.088
LN SIZE	0.123	0.541 <sup>b</sup>	0.102	0.035	0.403 <sup>b</sup>	0.294 <sup>b</sup>	0.053	0.153	0.192 <sup>a</sup>	0.087	0.073	−0.001	0.098	0.207	0.015
SIZE CHANGE	−0.114	−0.050	0.166 <sup>a</sup>	0.025	−0.165 <sup>a</sup>	−0.045	0.151	0.130	−0.027	0.094	0.190	0.182 <sup>a</sup>	0.069	0.088	0.043

a. Correlation is significant at the 0.05 level (2-tailed).

b. Correlation is significant at the 0.01 level (2-tailed).

**Table 6.6 Pearson correlation matrices between LAI and research variables (continued)**

Variables	(16)	(17)	(18)	(19)	(20)	(21)	(22)	(23)	(24)	(25)	(26)	(27)	(28)	(29)	(30)
DEBT EQUITY	0.172 <sup>a</sup>	0.105	0.198 <sup>a</sup>	0.074	−0.058	0.076	−0.025	0.148	0.071	0.169 <sup>a</sup>	−0.044	0.080	0.176 <sup>a</sup>	0.085	−0.028
ROA	0.140	0.185 <sup>a</sup>	0.095	−0.024	0.002	0.147	−0.250 <sup>b</sup>	0.019	0.177 <sup>a</sup>	0.062	0.006	−0.138	0.141	0.079	0.122
LN SIZE	0.153	0.560 <sup>b</sup>	0.381 <sup>b</sup>	0.129	−0.180 <sup>a</sup>	0.220 <sup>b</sup>	−0.391 <sup>b</sup>	0.080	0.314 <sup>b</sup>	0.139	−0.090	−0.002	0.173 <sup>a</sup>	0.272 <sup>b</sup>	0.011
SIZE CHANGE	0.071	0.073	0.195 <sup>a</sup>	−0.013	0.143	0.214 <sup>b</sup>	0.190 <sup>a</sup>	0.214 <sup>b</sup>	−0.043	0.064	−0.056	−0.057	0.125	0.011	−0.042

a. Correlation is significant at the 0.05 level (2-tailed).

b. Correlation is significant at the 0.01 level (2-tailed).

**Table 6.6 Pearson correlation matrices between LAI and research variables (continued)**

Variables	(31)	(32)	(33)	(34)
DEBT EQUITY	1			
ROA	0.055	1		
LN SIZE	0.114	0.291 <sup>b</sup>	1	
SIZE CHANGE	0.043	0.287 <sup>b</sup>	0.163 <sup>a</sup>	1

Correlation is significant at the 0.05 level (2-tailed).

Correlation is significant at the 0.01 level (2-tailed).

Note:

LAI: sanctions level of accounting irregularities. BOC SIZE: number of commissioners. UNRELATED: percentage of independent commissioners. OWNER BOC: percentage of shares held by commissioners. BLOCKING BOC: number of non-affiliated block holders on BOC. NSEAT: number of commissionerships in other firms. BOC EXPERT: number of financial/accounting experts on BOC. BOC COMP: number of members with some knowledge of finance or accounting on BOC. LEADERSHIP: dummy variable, 0 if BOC is led by related commissioner and 1 otherwise. BOC Score: 3 when chairman is not related and at least 1 financial expert is present on BOC; 1 when chairman is related and absence of financial expert; and 2 in all other cases. AUDIT SIZE: member of audit committee. UNRELAT AUDIT: percentage of unrelated members. AUDIT EXPERT: number of financial or accounting experts. AUDIT COMP: number of committee members with general knowledge of finance and accounting. AUDIT LEADER: 1 if audit committee led by financial expert commissioner and 0 otherwise. AUDIT Score: 3 if leader is financial expert and percentage of members is >66% financially expert and competent; 1 if leader is non-financial expert and absence of financial expert member; and 2 in all other cases. BOD SIZE: number of executive directors as top management team. BOD COMP: number of directors with financial literacy. CEO TENURE: number of years CEO held the office. BOD OWNERSHIP: percentage of shares held by directors. ICFR: 1 if there is disclosure of sufficient internal control system and 0 otherwise. COMPENSATION: salaries and additional compensation paid to directors. BOD Score: 3 if presence of financially competent director(s) and internal control systems is established; 1 if absence of financially competent director(s) and internal control function is not established; and 2 in all other cases. BIG4: 1 if the auditor is affiliated with Big Four and 0 otherwise. REFERRAL: equal 1 if the auditor is same as parent company auditor, 0 otherwise. AUDITOR CHANGE: equal 1 if there is change of auditor, 0 otherwise. AUDITOR TENURE: the number of years auditor engaged. AUDITOR Score: 3 if the auditor is affiliated with Big Four auditors and no change of auditor; 1 if the auditor is not affiliated with Big Four auditors and changes prior to the incidence; 2 in all other cases. OWNERBLOCK: percentage of shares held by block holders (+5%). DEBT EQUITY: leverage ratio (total debts/total assets). SIZE CHANGE: deviation of current and preceding period assets. LN SIZE: natural log of current period total assets.

Panel 1 of Table 6.6 contains the correlation matrix between LAI and BOC effectiveness variables. These preliminary correlation analyses show that the sanction level of accounting irregularities is negatively associated with the presence of accounting and finance experts on the BOCs ( $r=-0.175$ ,  $p<0.05$ ). Panel 2 shows that the audit committees' dimensions have negative correlation to the LAIs. However, only the number of audit committee members shows a significant correlation at  $-0.164$  ( $p<0.05$ ). Panel 3 shows that the LAIs have a significant and negative correlation to the existence of firms' internal control systems ( $r=-0.498$ ,  $p<0.01$ ). Panel 4 shows that presence of referral and high levels of audit opinion are negatively correlated to the LAIs. Quite the reverse, audit change without referral has a positive and significant correlation to the LAIs ( $r=0.171$ ,  $p<0.01$ ).

The QQ plot analyses are used to detect the outlier values within the dataset prior to running the test of parallel lines assumption. The test of normal distribution finds variables with a number of extreme values such as OWNER BOC, DEBT EQUITY and COMPENSATION. These values are replaced by using the mean of nearby points.

**Table 6.7 Test of parallel lines**

PM/FM	Models	-2 log likelihood	Sig.	Results
PM1	Null hypothesis	275.718	0.286	Slopes are the same
	General	261.490		
PM2	Null hypothesis	269.488	0.021	Slopes are different, additional multinomial regression needed
	General	249.916		
PM3	Null hypothesis	238.332	0.000	Slopes are different, additional multinomial regression needed
	General	204.856		
PM4	Null hypothesis	269.719	0.000	Slopes are different, additional multinomial regression needed
	General	228.898		
FM1	Null hypothesis	250.752	0.000	Slopes are different, additional multinomial regression needed
	General	218.895		
FM2	Null hypothesis	250.714	0.000	Slopes are different, additional multinomial regression needed
	General	218.918		
FM3	Null hypothesis	248.253	0.000	Slopes are different, additional multinomial regression needed
	General	213.882		
FM4	Null hypothesis	295.421	0.000	Slopes are different, additional multinomial regression needed
	General	250.410		

This study expects the p-values of the above tests are to be more than 0.05 to meet the parallel lines assumption. When the test fails to meet this assumption, additional analysis by using multinomial regression is conducted. Using multinomial regression means that this method will ignore the ordinal nature of the level of sanction of accounting irregularities and compare the reference category (those not doing so) with each other category individually.

As shown in Table 6.7, only PM1 meets the parallel lines assumption, which suggests slope coefficients are the same across the level of sanction of accounting irregularities. Since most PM and FM models have  $p\text{-value} < 0.005$ , this suggests that the sanction level imposed by BAPEPAM-LK is unordered in nature. Therefore, additional analyses by using multinomial regression are needed to find separate parameters (slopes) by comparing each category (fined and prosecuted firms) with control firms as the reference category (see sensitivity analyses). The following sections show the multivariate analyses to determine the effectiveness of individual corporate governance mechanisms and as a system to curb various incidences of accounting irregularities.

## **6.5 Effectiveness of individual corporate governance mechanisms**

This section reports and discusses the result of multivariate analysis on the relation between the sanction levels of accounting irregularities and individual corporate governance mechanisms. The ordinal regression controls factors such as block holders' shareholding, leverage and firm size, which strongly associated with the misreporting incidences. In order to enhance the reliability of the analysis, multinomial regression is used to analyse, especially, the model that did not met the parallel lines assumption.

Table 6.8 provides ordinal regression results for both the partial models (PM1 to PM4) in relation to H1 to H4. The PMs' findings reveal which dimension of the individual Indonesian corporate governance mechanisms is effectively reducing the likelihood of accounting irregularities. Moreover, the result of FM1 is used to confirm the findings of PMs, since this includes each aspect of those mechanisms as a score. Additional multinomial regression analyses are used to enhance the statistical relationships of PM2, PM3, PM4 and FM1 due to not meeting the parallel lines assumption.

**Table 6.8 Relationship between individual corporate governance dimensions and the seriousness of accounting irregularities**

	Predicted sign	Partial Models (PMs)			
		PM1	PM2	PM3	PM4
Constant of LAI = 0		1.986	2.834	3.725	2.676
Constant of LAI = 1		3.320	4.240	5.370	4.079
UNRELATED	–	–0.059			
OWNER BOC	?	0.619			
BLOCKING BOC	–	–0.040			
NSEAT	+	0.042			
BOC EXPERT	–	–0.394*			
BOC COMP	–	–0.062			
LEADERSHIP	?	0.307			
UNRELATED AUDIT	–		1.028		
AUDIT LEADER	–		0.114		
AUDIT EXPERT	–		–0.747*		
AUDIT COMP	–		–0.399*		
BOD SIZE	–			–0.011	
BOD COMP	–			0.041	
CEO TENURE	–			–0.025	
BOD OWNERSHIP	–			4.253*	
ICFR	–			–1.305*	
COMPENSATION	–			–0.764	
BIG4	–				–0.123
REFERRAL	–				–0.639*
AUDIT CHANGE	+				0.261
AUDIT TENURE	–				–0.156
OWNER BLOCK	–	–0.481	–0.460	–0.601	–0.498
DEBT EQUITY	+	0.011	0.015	0.050	0.018
ROA	+	–0.780	–0.735	–1.021**	–1.171*
LN SIZE	–	0.100**	0.139*	0.195*	0.138*
SIZE CHANGE	–	–0.221	–0.451	–0.274	–0.354
$\chi^2$		19.703	25.933	57.089	25.702
$\chi^2$ (p-value)		0.073	0.002	0.000	0.002
Pseudo R <sup>2</sup>		0.119	0.153	0.306	0.152
Overall prediction accuracy		51.90%	51.28%	69.23%	50.00%

\* and \*\* statistically significant at 5% and 10%, respectively.

### 6.5.1 Board of commissioners characteristics

Regarding H1 (Figure 4.1), the partial equation presented in the PM1 column of Table 6.8 shows that some BOCs characteristics influence the seriousness of accounting irregularities. This relationship has been established after including three types of control variables. The main finding of the PM1 highlights the importance members with

financial and accounting expertise (BOC EXPERT) in monitoring management's financial reporting process. The presence of this type of member makes it more likely to avoid accounting irregularities and reduce their seriousness ( $\alpha = -0.394$ ,  $p < 0.05$ ). Moreover, the existence of block holders' representatives (BLOCKING BOC with ownership > 5% of shares) and the presence of commissioners who are financially competent (BOC COMP) such as those not holding expert designations are among dimensions that could limit the seriousness of accounting irregularities. However, these are not statistically significant.

When the appointments of independent commissioners (UNRELATED) are used to 'tick the box' only, their presence on BOC does not influence a better level of BOC oversight roles in monitoring the credibility of financial reporting. This finding could be seen as an explanation of the insignificant effect of independent BOCs<sup>36</sup> on management misreporting behaviour of Indonesian firms. This finding is consistent with Djonieri's argument (2010) that those BOC members in Indonesia are usually influenced by the controlling owners on this supervisory board's decision making. Even the BOCs' membership comprises non-executive directors only; however, the majority of those are affiliated parties or grey directors. The current IDX listing rule requires at least 30% of BOC membership to be independent commissioners. However, 30% of membership is not enough resources to influence the majority of related members in preventing misreporting behaviour.

Other findings as seen from the results presented in Table 6.8, shareholding by the board of commissioners (OWNER BOC), commissioners' reputation (NSEAT) and BOCs' leadership (LEADERSHIP), show no statistical significance. On average, the commissioners only held as little as 3.70% of outstanding shares. Commissioners' reputation as measured using the total number of commissionerships (or directorships)

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<sup>36</sup> According to BAPEPAM-LK's definition, an independent commissioner is one that: (a) comes from outside the listed firms; (b) does not have any direct or indirect ownership in the listed firms; and (c) is not affiliated with the listed firms, as supervisory board member, executive director or major shareholder of the firms.

in other firms does not really constitute their reputations, but instead the role sharing among their own family interest or business groups<sup>37</sup>.

As shown in the FM1 of Table 6.10, BOC Score is negatively associated with the seriousness of accounting irregularities, but not significant on any convenient level. This does not support the proposed H1. Moreover, this study highlights that presence of member with financial or accounting expertise on the board of commissioners is an important factor in minimising the seriousness of accounting irregularities and deterring future incidences. However, the empirical finding also shows that the insignificant role of independent commissioner(s) means that there is a contrary concept of independent commissioners. It may be that independent commissioners might not act independently with other majority affiliated members. The reason that the relationship is inconsistent with agency theory, which suggests inclusion of outside independent directors as effective monitoring over management, is because of the fact that independent commissioners (or outside directors) have no other interests except as commissioners. Other facts also reveal that many Indonesian firms are still under control of a group of family members; as a consequence, the independent commissioners cannot and will not discharge their tasks effectively.

### **6.5.2 Audit committee characteristics**

PM2 of Table 6.8 shows the result of H2 concerning the effectiveness of audit committees in reducing the seriousness of accounting irregularities. The analysis reveals that member(s) with expertise (AUDIT EXPERT) and competence (AUDIT COMP) are among the significant aspects in curbing these incidences. The presence of financial and accounting experts on the audit committee is negatively associated with the seriousness of accounting irregularities ( $\alpha = -0.747$ ,  $p < 5\%$ ). A negative relationship ( $\alpha = 0.399$ ,  $p < 5\%$ ) has also been found with the number of those with general financial competence.

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<sup>37</sup> The Commission for the Supervision of Business Competition in Indonesia (*Komisi Pengawas Persaingan Usaha* or KPPU) has released guidance concerning the prohibition of interlocking directorship. Within direct interlock, companies have a horizontal relationship that creates capability to manipulate the market price, market share and aggregate production.

The relationship is consistent with that of other previous studies (Bedard, Chtourou & Courteau 2004; Farber 2005; Smaili & Labelle 2009).

In Indonesia, one of the independent commissioner members is *ex officio* as audit committee chairman. The financial literate chairman (AUDIT LEADER) is positively associated with the case seriousness, but the relationship is statistically insignificant. This finding does not support the current Indonesian policy (*Peraturan BAPEPAM IX.I/2004*) which recommends the presence of financially literate members only on the audit committee, rather than a financial expert as in the US (the SOX Act 2002). The finding is consistent with the study by a Smaili and Labelle (2009), which suggests policy to be tightened.

The most recent BAPEPAM-LK and IDX's listing rule requires that at least one of the members of the audit committee must have an accounting or finance "education background". Moving to what has been regulated by the US SOX by employing "financial experts" will become a long process due to the small number of Indonesian CPAs (IAPF 2010) and other "financial experts" designation holders, such as CIA, CISA and CPA. Therefore, the study results suggest considering the genuine experience aspects including skills and knowledge: to review company financial information, to prevent errors and frauds, to improve the quality of financial disclosure and to review the independence of external auditors, rather than the current requirement of an accounting and/or finance education background only.

Overall, the results of FM1 in Table 6.10 show that the AUDIT Score is negatively associated with the seriousness of accounting irregularities, but not significant. Therefore, this result does not support the proposed H2. Again, the detailed results of PM2 find that it is important to underline the presence of financial experts in order to discharge audit committees' role effectively.

### **6.5.3 Board of directors characteristics**

PM3 of Table 6.8 shows the results of Indonesian boards of directors in relation to H3. As mentioned earlier, this board only consists of executive directors, those who are



members of the top management team. PM3 shows the dimension of the boards that are effectively reducing the seriousness of accounting irregularities. There are two aspects showing significant coefficients in this model: internal control systems and shareholding by executives.

This study finds that the existence of internal control systems (ICFR) is statistically significant ( $\alpha=-1.305$ ;  $p\text{-value}<5\%$ ) in reducing the seriousness of incidences. The finding suggests that when the business entity has a set of rules as guidance for the desired operational behaviours, the organisation has mechanistic structure to have a stronger ethical framework for employees of the organisation including the executives. Praise for the important role of internal control for financial reporting processes has a strong function to limit the seriousness of these misreporting incidences. This is consistent with the opinion of Smaili and Labelle (2009) and supports the SOX Act of 2002's implementation of an independent assessment of firms' internal control over financial reporting.

In addition, shareholding by executive officers (BOD OWNERSHIP) positively influences the seriousness of accounting irregularities ( $\alpha=4.253$ ,  $p<5\%$ ). As the average of their ownership is as little as 1.8% of total shares, executive officers may only be concerned with current earnings. The reason that this situation makes for higher probability that a financial statement could be stated unfairly is that the management could benefit from this unethical reporting with the objective of keeping the share price high and increasing the value of their personal shares to be sold in the future (Yang, Lai & Tan 2008). In addition, as shown in Table 6.5, there are firms with executive shareholding  $>50\%$  of common stocks. This suggests that the top management team has sufficient voting power to guarantee their future employment and as a result, the situation becomes ineffective to align managers in the best interest of shareholders.

Longer-tenured president directors/CEOs (CEO TENURE) are less likely to engage in risky behaviour by sacrificing their reputation, but this characteristic is not significant. This result indicates that CEO tenure, in terms of years of directorship experience, could enable CEOs to manage companies effectively. This is not consistent with previous

studies, especially those based on echelon theory (Dunn 2004; Gray & Cannella Jr 1997; Hambrick & Mason 1984).

In terms of BOD remuneration<sup>38</sup> (COMPENSATION), after controlling for size differences using the scale of total firm revenue, there is also no evidence of a statistical influence of this compensation towards serious incidences of accounting irregularities. The study finds that companies' executives (all members of the top management team) with accounting irregularities earned, on average, IDR10.07 billion (USD1.11 million) per year over the period of perpetrating accounting irregularities. In contrast, the executives of the matched sample of firms earned only IDR9.88 billion (USD1.09 million) per year on average in total cash compensation during this same period.

This study finds that the total number of directors on the BOD (BOD SIZE) and presence of members with financially literacy (BOD COMP) are not statistically significant at any conventional level. The number of executive directors on a BOD represents a company's resources capacity in terms of skills and experience. However, in some cases of listed firms, the top management team may be a family connection and political appointees who have a limited understanding of running a business. Many of them have little respect for the concepts of financial disclosure and transparency, and also the benefit of corporate governance implementation. This situation is similar to what has happened in China (see, for example, Chen et al. 2006; Firth, Fung & Rui 2007).

To sum up firms' top management team characteristics, the coefficient of BOD Score in FM1 of Table 6.10 is negative and significant ( $\alpha=-0.600$ ;  $p\text{-value}<5\%$ ). As the score is established according to the NCG (2006) guideline, it suggests that the second tier of this board of directors should be of sufficient member to suit the business complexity in order to provide enough resources including, especially, internal control over financial reporting. Therefore, this study supports a regulation of firms' CEOs and CFOs, on behalf of boards of directors to certify financial statements. This certification ensures

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<sup>38</sup> Total BOD compensation is computed as the sum of the salary+bonus+all other pays that are disclosed in annual reports and firms' audited financial statements.

their personal liability for any false statements as the result of firms' internal control mechanisms.

#### **6.5.4 Auditor quality characteristics**

PM4 of Table 6.8 shows the results of auditor quality aspects in relation to H4. The study finds that a situation where the listed companies appoint the same auditor as the holding firm (REFERRAL) is negatively associated with the level of accounting irregularities ( $\alpha = -0.639$ ,  $p < 5\%$ ). This referral constitutes another explanatory variable of audit quality where auditing engagement is regarded as free from conflict of interest between executive officers and auditor. This result is consistent with Branson and Breesch's study (2004).

Those audited by Big Four auditors (BIG4) are negatively associated with the level of misreporting behaviour, but it is not significant at any conventional level. The result suggests that this external governance mechanism has no effect on minimising the seriousness of accounting irregularities. In case of a general audit engagement, Big Four and other big audit firms are not different in providing a high-quality audit by their consideration of any material errors or fraud. In Indonesia, only foreign auditors who come from a country with mutual recognition of their audit profession can establish their own audit firms. So far, Big Four firms are affiliated with local public accountants to provide services to Indonesian companies.

The other two dimensions of audit quality (AUDITOR CHANGE and AUDIT TENURE) are not statistically significant. This suggests that incoming auditors do not exercise tighter controls over firms that have just switched from previous auditors. Longer-tenured and change of auditor are not going to lead to a high level of erroneous financial reporting, since this only complies with auditor rotation rules. This is inconsistent with the Lazer, Livnat and Tan (2004) study in the US, which investigated the effect of auditor changes on financial statement restatement.

As shown in Panel FM1 of Table 6.10, AUDITOR Score has a negative and significant association with the seriousness of accounting irregularities ( $\alpha = -0.259$ ;  $p\text{-value} < 10\%$ ).

Even though the PM result model shows that some individual aspects of audit quality are insignificant, the overall score suggests the important aspect of auditor verification over a firm's financial statements. The likelihood of a serious case might be anticipated by considering the proper high degree of auditor independence including referral.

**Table 6.9 Summary of the role of individual governance mechanisms**

<b>Hypotheses</b>	<b>Prediction relation with the LAI</b>	<b>Results consistent with hypothesis</b>	<b>Level of significance</b>
H1 The BOC's effectiveness is negatively associated with the gravity of accounting irregularities incidence.	—	No	P-value >10%
H2 The audit committee's effectiveness is negatively associated with the gravity of accounting irregularities incidence.	—	No	P-value >10%
H3 There is an association between Indonesian BODs' dimensions and the gravity of accounting irregularities incidence.	—	Yes	P-value <5%
H4 The auditor's effectiveness is negatively associated with the gravity of accounting irregularities incidence.	—	Yes	P-value <10%

Table 6.9 provides a summary of role of individual corporate governance mechanisms in relation to the seriousness of accounting irregularities. The findings suggest strengthening the oversight role of boards of commissioners, including their audit committee, over financial reporting. Here, a strong requirement to ensure their diligence is becoming important. Additional red flags confirm that accounting irregularities are more serious when: (1) there is absence of a financial expert on the BOC and on the audit committee; (2) management has a considerable shares held by officers and weak internal control; and (3) auditor is appointed by an internal party without a referral from block holders or the parent company.

## 6.6 Effectiveness of corporate governance as a system

H5 considers a negative correlation of the interaction between the effectiveness of the board of commissioners, the audit committee and the auditors with the seriousness of accounting irregularities. It is predicted, that as the internal and external factors work collaboratively, the order of serious incidences decreases. To examine this interaction effect (as a system), this study estimates main effect models (FM1) and full interaction models that include FM1 and two-way interactions on the main oversight roles. As the effectiveness of the system probably comes in part from their synergy, the interaction terms of BIG4\*UNRELATED AUDIT (FM2), BOC SCORE\*AUDIT Score (FM3) and AUDIT Score\*AUDITOR Score (FM4) are then introduced.

The FM1 determines the simultaneous effect of the BOCs and audit committee, the BOD, and the auditor on the severity of accounting irregularities. Each score is used to support the investigation of partial models, which are hypotheses 1 to 4, as to whether overall firms' mechanisms are working effectively or not. Simultaneously, all aspects of corporate governance dimensions are negatively associated with cases' seriousness. However, the higher ranks of BOCs and their audit committee show no statistical significance. This is contrary to their normal role expectation. The simulation reveals that the LAI is more severe when the audit quality is low (AUDITOR Score;  $\alpha = -0.423$ ;  $p < 10\%$ ) and integrity of the management board weak (BOD Score;  $\alpha = -1.262$ ,  $p < 5\%$ ). The model fits (Chi-square=44.669,  $p$ -value<0.05%) with overall prediction accuracy about 65%.

The FM2 model determines the presumed synergy between the presence of independent commissioners on audit committees and audit engagement with Big Four auditors, as measured by the coefficient of UNRELATED\_AUDIT\*BIG4, on the severity of accounting irregularities. The effect of this interdependence is negative, but not significant. As shown in the result of FM2 of Table 6.10, the BOD Score is negatively associated with the severity ( $\alpha = -0.599$ ,  $p$ -value<0.05). The model has prediction as accurate as what the FM1 does at 64.74%. The finding is inconsistent with Smaili and Labelle's study (2009). As observed in prior analyses, this might be explained as being that independent commissioners' presence does not really represent real oversight

activities. Therefore, their interaction with BIG4 does not improve firms' reporting quality. Again, this study underscores the importance of management to improve the quality and integrity of financial reporting.

**Table 6.10 The link of corporate governance as a system and the level of accounting irregularities**

	Predicted Sign	FM1	FM2	FM3	FM4
Constant of LAI = 0		1.548	1.592	0.012	2.085
Constant of LAI = 1		3.064	3.109	1.549	3.611
BOC SCORE	–	–0.182	–0.178	–0.811**	–0.165
AUDIT SCORE	–	–0.131	–0.130	–0.936**	0.174
BOD SCORE	–	–0.600*	–0.599*	–0.562*	–0.606*
AUDITOR SCORE	–	–0.259**	–0.238	–0.292*	–0.014
UNRELAT AUDIT * BIG4	–		–0.164		
BOC SCORE * AUDIT SCORE	–			–0.348**	
AUDIT SCORE * AUDITOR SCORE	–				–0.140
OWNER BLOCK	–	–0.316	–0.303	–0.334	–0.308
DEBT EQUITY	+	0.058**	0.058**	0.065*	0.054**
ROA	+	–1.148**	–1.107**	–1.064**	–1.135**
LN SIZE	–	0.162*	0.162*	0.157*	0.162*
SIZE CHANGE	–	–0.034	–0.034	–0.157	0.015
$\chi^2$		44.669	44.707	47.168	45.436
$\chi^2$ (p-value)		0.000	0.000	0.000	0.000
Pseudo R <sup>2</sup>		0.249	0.249	0.261	0.253
Overall prediction accuracy		64.74%	64.74%	65.38%	65.38%

\* and \*\* statistically significant at 5% and 10%, respectively.

The FM3 model shows that the coefficient of the interaction term BOC Score\*AUDIT Score is negative and significant ( $\alpha$  = –0.348, p-value < 0.10). This provides evidence that diligent monitoring carried out by BOCs and audit committees may reduce the seriousness of misreporting behaviour. The model explanatory power (pseudo R-square) is the highest among the proposed models. This means that the collaboration between a firm's supervisory board and its audit committee is a promising way to deter accounting irregularities. Moreover, other main effects show statistical significance in relation to severity. This suggests that the effectiveness of BOC and audit committee collaboration can reinforce the Indonesian BOD and auditors in lowering the seriousness of

accounting irregularities. Prediction accuracy and pseudo R-square are the highest among the full models, account for 65.38% and 26.10%, respectively.

The FM4 model determines the relationship between the collaborative effect of a firm's audit committee with an external auditor and the seriousness of accounting irregularities. The interaction term  $\text{AUDIT Score} * \text{AUDITOR Score}$  is negatively associated with severity, but not significant. The overall prediction accuracy is still the same as FM3 with a slightly lower pseudo R-square at 25.30%. This last finding suggests ineffectiveness of audit committees, which are failing to fulfil one of their main duties with respect to the independence of external auditors (NCG 2006). In addition to selecting, evaluating and proposing to a firm's BOC which external auditors are to be nominated for approval by the annual shareholders meeting, an audit committee's duty is to discuss with the external auditor the results of their audit findings, whether or not any error or fraud (accounting irregularities) are contained in the audit figures, and all the matters required by Indonesian auditing standards (SPAP). Again the study fails to see any empirical evidence of committee and auditor collaboration in Indonesian listed firms. This is inconsistent with the Canadian study by Smaili and Labelle (2009).

Generally, the FM3 finding supports H5, which predicts that when there is synergy among oversight roles within corporate governance mechanisms, the likelihood of accounting irregularities severity decreases. The situation when firms' BOC and their audit committees are diligent enough to discharge their roles and responsibilities ends up reinforcing the effectiveness of governance dimensions in lowering the level of seriousness of accounting irregularities. There is a need to regulate a detailed disclosure of what has been conducted by each structure of the corporate governance mechanisms to ensure that each role is performed effectively.

## **6.7 Sensitivity analyses**

To further the robustness of the results obtained, this study conducts some alternative measurements. The level of sanction imposed by BAPEPAM-LK to Indonesian listed firms might not really be ordinal in nature. Most of the models (see Table 6.3) do not

meet the test of parallel lines. Therefore, first, this study is employing multinomial regression to analyse individually the likelihood within fined firms (LAI=1) and prosecuted firms (LAI=2) and comparing with the reference group (LAI=0). Second, the study includes the effect of industry. Listed firms in a highly regulated industry including finance (JASICA 81-89) and investment (JASICA 91-99) are subject to more scrutiny from external monitoring including an authoritative supervision. Both take value 1 and 0 otherwise.

As shown in Table 6.3, the results documented earlier show that the models' slope coefficients are not the same. According to Hair et al. (1995), individual comparison of reference group to each other category is needed using multinomial regression. This compares LAI=0 to LAI=1, and LAI=0 to LAI=2. This method is actually an extension of binary logistic regression. The sanction levels of accounting irregularities (LAI) really have an order in nature according to their seriousness. However, the test of parallel line shows that the distance between sanctions is different. This study re-runs the previous analysis (ordinal regression) using the multinomial approach. The results are reported in Table 6.11 and 6.12.

As shown in Table 6.11, generally the results documented earlier are robust when multinomial analyses are used. The likelihood of firms to be commit moderate accounting irregularities (LAI=1) decreases when: there is presence of BOC with accounting and finance expertise; firms establish sound internal control over financial reporting; and auditors are appointed according to referral from firms' holding company. With more serious firms' accounting irregularities (LAI=2), there are more conditions to be considered including: the effectiveness of audit committees; significant number of managerial owners; effective internal control; and long-tenure of external auditors. There are different individual red flags for each LAI that correspond to the seriousness level of accounting irregularities that might occur.

In addition Table 6.11 results, column PM1 of Table 6.12 shows the scoring of corporate governance dimensions related to H1 to H4 testing. Statistical analysis reveals the acceptance of BOD effectiveness (H3). The likelihood to commit moderate



accounting irregularities (LAI=1) decreases when the overall quality of the top management team (BOD Score) increases. Other dimensions are negatively associated with seriousness, but insignificant. Furthermore, the more serious cases (LAI=2) need more mechanisms to curb their occurrence. Quality of overall managerial monitoring (BOD Score) and external assurance (AUDITOR Score) are effective in lowering the level of accounting irregularities. However, the oversight roles performed by firms' supervisory board (BOC Score and their AUDIT Score) are statistically insignificant. This last finding underlines the weak role of BOC and audit committees over Indonesian listed firms' financial reporting.

As shown in Table 6.12, the simultaneous effect across the models is significant (p-value of  $\chi^2 < 5\%$ ) with overall prediction accuracy ranging between 68.60% and 72.40%. The proposed interaction effect of UNRELATED AUDIT\*BG4, BOC Score\*AUDIT Score, and AUDIT Score\*AUDITOR Score has mostly negative directions, but is insignificant. Furthermore, an important finding to note is the result of FM3, which proposes interdependence between a supervisory board (BOC Score) and its audit committee (AUDIT Score). The analysis shows a statistical significance among corporate governance dimensions when supervisory boards and audit committees as company oversight structures show a high quality of collaboration. Therefore, it is necessary to regulate how companies to disclose whether or not diligent oversight showing collaborative actions over firms' financial reporting has been conducted.

**Table 6.11 Multinomial regression results for additional partial models**

	Predicted Sign	Partial Models (PMs)							
		PM1		PM2		PM3		PM4	
		LAI=1	LAI=2	LAI=1	LAI=2	LAI=1	LAI=2	LAI=1	LAI=2
Constant		-1.510	-13.238	-.032	-25.520	-4.095	-24.784	-1.022	-12.707
UNRELATED	-	2.713	-2.568						
OWNER BOC	?	2.405	2.660						
BLOCKING BOC	-	-0.245	-0.081						
NSEAT	+	0.052	0.096						
BOC EXPERT	-	-0.683**	-0.579						
BOC COMP	-	-0.033	-0.336						
LEADERSHIP	?	0.708	1.055						
UNRELATED AUDIT	-			0.859	6.278*				
AUDIT LEADER	-			-0.440	0.980				
AUDIT EXPERT	-			-0.538	-4.308*				
AUDIT COMP	-			-0.113	-2.236*				
BOD SIZE	-					0.114	-0.259		
BOD COMP	-					-0.257	0.325		
CEO TENURE	-					-0.068	-0.022		
BOD OWNERSHIP	-					3.621	13.792*		
ICFR	-					-3.031*	-3.688*		
COMPENSATION	-					-0.764	-13.344		
BIG4	-							-0.284	-0.149
REFERRAL	-							-1.433*	-1.599
AUDIT CHANGE	+							0.655	-1.601
AUDIT TENURE	-							0.299	-3.044*
OWNER BLOCK	-	-0.172	-1.923	-0.325	-2.005	-0.319	-2.493	-0.415	-2.242
DEBT EQUITY	+	-0.136	0.089	-0.073	0.070	-0.066	0.034	-0.068	0.075
ROA	+	-0.259	-3.556*	-0.355	-4.557*	-1.239	-5.091*	-0.116	-6.134*
LN SIZE	-	0.026	0.480*	0.012	0.908*	0.226	0.984*	0.027	0.645*
SIZE CHANGE	-	-1.003	0.099	-0.775	-.782	-0.274	0.022	-0.710	-0.822
$\chi^2$		45.217		46.961		98.930		45.948	
P-value of $\chi^2$		0.005		0.000		0.000		0.000	
Pseudo R-square		0.298		0.306		0.553		0.300	
Overall prediction accuracy		59.40%		60.30%		75.00%		57.10%	

Note: Reference category is 0.

**Table 6.12 Multinomial regression results for additional full models**

	Predicted Sign	FM1		FM2		FM3		FM4	
		LAI=1	LAI=2	LAI=1	LAI=2	LAI=1	LAI=2	LAI=1	LAI=2
Constant		2.428	−14.065	3.316	−14.334	4.385	−8.414	2.289	−16.426
BOC SCORE	−	−0.025	−0.808	−0.098	−0.765	−0.834	−3.060*	−0.020	−0.714
AUDIT SCORE	−	−0.047	−0.817	−0.096	−0.804	−0.958	−4.096**	0.025	0.161
BOD SCORE	−	−1.629*	−0.897**	−1.657*	−0.914*	−1.618*	−0.882**	−1.631*	−0.936**
AUDITOR SCORE	−	−0.308	−0.966*	−0.501	−0.907**	−0.347	−1.130*	−0.233	−0.0224
UNRELAT AUDIT * BIG4	−			1.781	−1.093				
BOC SCORE *AUDIT SCORE	−					−0.402	−1.427		
AUDIT SCORE*AUDITOR SCORE	−							−0.032	−0.496
OWNER BLOCK		−0.289	−1.788	−0.469	−1.900	−0.291	−1.935	−0.288	−1.684
DEBT EQUITY		−0.031	0.128	−0.029	0.138	−0.027	0.159*	−0.030	0.130
ROA		−1.387	−4.128*	−1.723	−4.133*	−1.394	−4.038*	−1.402	−4.243*
LN SIZE		0.059	0.718*	0.048	0.725*	0.053	0.702*	0.058	0.742*
SIZE CHANGE		−0.081	−0.157	−0.073	−0.170	−0.150	−0.206	−0.075	−0.091
$\chi^2$		75.215		76.894		78.373		75.907	
P-value of $\chi^2$		0.000		0.000		0.000		0.000	
Pseudo R- square		0.450		0.458		0.465		0.454	
Overall prediction accuracy		69.90%		68.60%		72.40%		69.90*	

Note: Reference category is 0.

## 6.8 Summary

This study investigates the effect of individual corporate governance mechanisms and as a system on the seriousness of accounting irregularities incidences. The chapter provides empirical evidence for testing the hypotheses developed in chapter 4.

On a univariate basis, compared to firms exhibiting accounting irregularities, non-accounting irregularities firms generally have (a) financially expert members both on their board of commissioners and audit committee; (b) established internal control systems over managerial activities, especially on firms' financial reporting; (c) a long-tenured president director (CEO) supported by some executive directors with sufficient financial competence; and (d) existing referral on auditor appointment. In addition, those who comply with the disclosure regulation have received more unqualified opinions on their financial statements rather than firms with accounting irregularities.

On a multivariate basis, consistent with prior studies, this research finds that the occurrence of serious accounting irregularities is negatively associated with the severity of accounting irregularities. Specifically, results of analyses indicate that issuers in default have less integrity of management (BOD Score) and lack of auditor independence (AUDITOR Score). This study fails to document an effective BOC and their audit committee in lowering seriousness of accounting irregularities. An unfortunate situation for Indonesia shows that BOCs and audit committees are not diligent enough in supervising the management regarding financial reporting responsibility. In more detailed investigation, accounting irregularities are more serious when: (a) there is absence of a financial expert on the BOC and on the audit committee; (b) management has a considerable shares held by officers and weak internal control; and (c) auditor is appointed by an internal party without a referral from block holders or a parent company.

The empirical results of this study suggest that BOCs and their audit committee are not yet effective in overseeing firms' financial reporting and auditing process in preventing serious cases of accounting irregularities. The prevention of accounting irregularities is more likely when BODs show their integrity by disclosing the internal control mechanisms. Auditors are deemed to be more effective in limiting accounting

irregularities when they are really independent. This is not only related by their reputation and tenure, but also strong support from firms' block holders. Overall, this study supports Indonesian regulatory efforts to improve the quality of financial reporting by strengthening independent commissioners' competence and promoting the governance process.

The next chapter, chapter 7 discusses the implications of the results reported in this chapter, together with the limitations of this study and directions for future research.

## **CHAPTER 7    CONCLUSIONS AND IMPLICATIONS**

### **7.1    Introduction**

Within this study, chapter 2 and 3 provided a literature review on the role of governance mechanisms in preventing accounting irregularities and the nature of corporate governance systems in Indonesia. Following this review, a research framework and five research questions were developed in chapter 4, followed by the research methods in chapter 5. In chapter 6, the results of the study were outlined with emphasis on a general summary of accounting irregularities incidences in Indonesia, followed by statistical analyses of the governance variables. This chapter provides the conclusion of the research and assesses contributions, limitations and suggestions for future study.

### **7.2    Conclusion of the study**

The issue of accounting irregularities – errors and frauds – is found worldwide and in Indonesia too. Specifically, this study found that, on average, there were more than 170 listed companies subject to disciplinary actions in the form of fines and 30 others investigated for their serious offences. These might seriously undermine investors' confidence in the Indonesian market. With regard to the advantages of the two-tier board structure adopted in Indonesia, this study investigates the extent to which Indonesia's two-tier corporate governance mechanisms act as an effective tool for protecting the investing public against various levels of accounting irregularities.

The study does so by examining not only the occurrence of such erroneous financial reporting but also its seriousness. Therefore, this research design allows scholars to focus on the corporate governance dimensions that are likely to cause the most serious non-compliance with financial reporting requirements. Using a strong reliable source of cases handled by BAPEPAM-LK law enforcement actions, this study includes detail of 78 firms with various accounting irregularities and another 78 firms with no disclosure offences during the period 2000–2009. Furthermore, the details of corporate governance mechanisms and some financial aspects were collected from firms' annual reports.

Hypotheses were proposed and statistically tested through the investigation of both univariate and multivariate tools. The existence of significant effects was regarded as indicative of the relationships between accounting irregularities incidences and their corporate governance variables. The following conclusions can be drawn from the present study.

First, accounting malfeasance occurred in a variety of industries. The result of this investigation revealed that the finance and trade/service/investment industries had the largest proportion of samples (each 21.79%). This was followed by the consumer goods industry (14.10%) and then basic industry and miscellaneous industry (each 12.82%). Other industries within JASICA have also been affected. These findings suggest that any action to deter, prevent or detect accounting irregularities should not be limited to any particular industry.

Second, the common methods of financial misbehaviour to emerge from this study are the misapplication of accounting information and manipulation or falsification. Among the methods of misapplication used, firms are failing to disclose material information. This suggests that there are serious problems of disclosure compliance among listed firms. The next misuses of accounting information are transactions with conflicts of interest and with unauthorised components. These incidences are common in corporations with controlling shareholders in management or with family-based ownership. This is consistent with previous studies (Lukviarman 2004; Shleifer & Vishny 1997) regarding the shift pattern of agency problems from the traditional shareholders-managers perspective to controlling-minority shareholders conflict.

Surprisingly, the results of the investigation show that in 66.67% of cases studied, the corporation itself is responsible for the accounting irregularities. These majority indictments could be interpreted as weak law enforcement due to lack of clarity about who the indicted is. Financial statements are the responsibility of a firm's board of directors (management board). Therefore, the finding is inconsistent with the spirit of CEO and CFO certifications of financial information (Geiger & Taylor III 2003). The certification is regulated by BAPEPAM-LK Rule No: VIII.G.1.1 concerning the board of directors' (management boards') responsibility for financial statements.

With regard to the internal perpetrators, president directors (CEO) were the most responsible for the cases. Prevention of accounting irregularities must, therefore, start at the highest level structures of a company (tone at the top). Commissioners and senior staff were the next most common internal parties responsible for accounting irregularities. Their high involvement is due to their capability to override corporations' internal control and to lead lower staff to conceal financial statements. In some cases, supervisory board members were also indicted for their negligence and underperformance. None of the cases were initiated by operational-level employees, including senior or junior accounting staff. This suggests to the governing bodies to strengthen law enforcement and to the two-tier boards to set the tone at the top. The correct tone is unrelenting moral messages, such as codes of conducts that are shared across the company, and that numbers are representatively faithful.

Third, univariate analysis revealed mean differences among corporate governance dimensions and other variables of this study. From the internal perspectives, listed companies with small sized boards of commissioners (supervisory boards) employing financial experts on their boards and will audit committees are less likely to commit a serious misstatement of financial information. The next major finding was the dimensions of boards of directors (management boards) in relation to the integrity of financial reporting. The study has also shown that sound internal control systems and the presence of financially competent officers on the top management team are ultimately important to avoid the incidence of misstatements.

From the external perspectives, this study found that audit quality and government policy are also important components of a strong framework for an effective corporate governance mechanism. In Indonesia, to some extent audit quality does not seem to differ according to the sources of auditors. Local audit firms that are associated with the Big Four auditors do not always provide a better level of assurance service than their purely local counterparts. This is due to the legislation that requires local knowledge proficiency for licensing. The mean difference analysis revealed that an unqualified opinion and the existence of a referral auditor are significantly higher for listed companies with no accounting irregularities. In turn, there was strong evidence that the enforcement roles performed by BAPEPAM-LK and other SROs are still limited.



On the whole, the findings of this study support the hypotheses that generally the incidence of accounting irregularities is negatively associated with the quality of corporate governance in the Indonesian two-tier board system. The level of misstatement in financial information is, indeed, more severe when: (1) there is an absence of financial experts both on supervisory boards and their audit committees; (2) there is a short tenured-CEO with poor firm internal control systems; and (3) an auditor is solely appointed by the firm's board of commissioners without the agreement of the block holders or holding company (known as referral). The most obvious finding to emerge from this study is that there are general weaknesses of the board of commissioners and audit committees in discharging their supervisory role over managements. It has also been shown that boards of commissioners, who should act in a similar way to that of outside directors (in the unitary board structure), predominantly comprise the inside members. At least one third of them are outside independent commissioners, without sufficient resources. However, the board of commissioners and audit committee could be an effective tool in mitigating reporting incidences when they show a high quality of collaboration. It is believed that this study is substantial and provides valuable information with regard to the effective functioning of the Indonesian two-tier corporate governance structure. It is believed that corporate governance mechanisms, auditors and governing bodies, along with investors, will gain advantages from the findings presented in this study.

### **7.3 Research implications**

The empirical results of the study demonstrate that corporate governance mechanisms can be employed to predict not only the likelihood of fraud occurrence, but also the seriousness of accounting irregularities. The key determinants that are useful in predicting the severe cases are the absence of financial experts on both supervisory boards and audit committees, short-tenured CEOs, poor quality of firms' ICFR, auditors who not independent and a lack of interaction among governance mechanisms. This study has several important implications, which include theoretical implications and practical implications. These implications are discussed in the following sections.

### **7.3.1 Theoretical implications**

In examining the robustness of previous studies (Abbott, Parker & Peter 2004; Beasley 1996; Beasley et al. 2000a; Smaili & Labelle 2009), the findings of this study contribute to the body of knowledge in the area of corporate governance with the two-tier board structure. These findings offer an understanding of the role of corporate governance mechanisms in this context, including aspects of an effective supervisory board and their audit committee and also dimension of firms' management boards. In addition, this study summarises the evidence from those indicted for their accounting irregularities as 'red flags' for investigative purposes and, at the same time for preventing serious incidences recurring.

Existing knowledge of effective corporate governance frameworks has focused on developed countries' corporate governance; the present study specifically contributes to this body of literature by providing evidence of corporate governance practices in Indonesia. In doing so, the results of this research add to the knowledge base for countries with emerging economies. To some extent, corporations in this country have, on average, a high ownership concentration, less transparency, and a weaker governance framework compared to those in developed countries, such as Australia, the US or Canada. Further, from the perspective of governance mechanisms, the results of this study show that Indonesian listed firms must take into account the benefits of collaboration among individual roles within governance gatekeepers. The importance of teamwork could reduce the asymmetrical information problems among the main two-tier board processes.

To the best of our knowledge, this research will serve as a base for future studies to determine the effectiveness of a two-tier board structure that consists of supervisory and management boards, in relation to the high quality of corporation disclosures. The indications of effective characteristics of the two-tier board system are a guide towards better practices for running corporations in the best interests of stakeholders. This implication is in accordance with prior studies (see, for example, Chen et al. 2006; Firth, Fung & Rui 2007) that have demonstrated the benefit of full separation between outside and executive directors. This study result goes beyond the one-tier board

structure and supports Smaili and Labelle's (2009) study of a Canadian corporate governance system.

Furthermore, the methodology employed in this present study provides guidelines for further study in this area, specifically in the case of studying the characteristics of financial scandals. The guidelines include: the approach to investigate a law enforcement data that is kept confidential by regulatory offices; the data collection procedure; and the method used to analyse the data, which has an ordinal nature. The main contribution of this research resides in ordinal regression, which examines the relationship between corporate governance and the seriousness of accounting irregularities.

### **7.3.2 Practical implications**

From a practical point view, these findings provide feedback to those involved in scaffolding the Indonesian corporate governance (e.g. NCG and IAPI) and also policymakers (e.g. BAPEPAM-LK and IDX) to assist in strengthening policies that support the importance of red flags in the prevention of accounting irregularities. Incorporating the sample description in chapter 5 and the findings in chapter 6, a number of practical implications can be derived.

1. To strengthen the guideline for characteristics of an effective framework of corporate governance in Indonesia, including certain aspects pertaining to boards of commissioners, audit committees and management boards as follows:
  - The regulators of corporate governance should seriously consider the lack of supervision provided by a board of commissioners over the management due to their nature of inside relationships and incompetence, with only one third independent (outside) members. The results indicate that as the expertise increases, the likelihood of serious accounting irregularities decreases. Perhaps the effectiveness of the board of commissioners would be greater if the board had to appoint expert members or a majority of independent commissioners to form the boards of listed companies within the terms of listing requirements.
  - As the establishment of an audit committee is compulsory rather than optional, the distinction in this between firms with accounting irregularities and those not

so is no longer apparent. The incidence of accounting scandals seems to continue to occur while audit committee regulations seem to have been fulfilled as ‘ticking the box’ only. Therefore, the public has serious doubts about the effectiveness of audit committees in undertaking their duties. This could be taken as a strong indication that current regulations do not go far enough to ensure their effectiveness. The results of this research support the idea that all members of the audit committee should be financially literate and at least one member should possess genuine accounting expertise. The adoption of, for instance, the term ‘Audit Committee Financial Expert (ACFE)’ by the SEC Regulation S-K in item 401(h) could be considered a guideline ensuring committee effectiveness in overseeing and monitoring the financial reporting process of a listed company. An ACFE does not have education only, but also experience such as CFOs, supervisors and assessors of the firm’s performance with respect to the preparation and evaluation of financial statements. There should be a nomination and remuneration committee to recruit the best possible candidates and to give appropriate incentives according to recent market value and committee performance.

- Financial statement preparation and reporting processes are the responsibility of the firms’ management. In the Indonesian two-tier context, the management is the management board. As shareholding by executives and internal control quality have been found to determine the likelihood of serious accounting irregularities, taken together the results support an independent assessment of significant deficiencies and material weaknesses with regard to firms’ internal control systems. As there is increasing shareholding by top management teams, as well as ownership concentration within related parties and family members, it is therefore necessary to re-align managers in the best interest of all shareholders.

2. External auditors or public accountants can use the models and the findings of significant red flags as tools to enable them to predict the audit risks that other auditors would assess in similar circumstances and, in turn, determine the score of audit engagement or even protect their actions in a lawsuit. Financial expertise is regarded as one of the critical competencies for those who supervise and/or manage listed firms; however, as of August 2010 there are only 920 Indonesian CPAs (IAPI

2010). As noted from these numbers, Indonesia has relatively few certified professionals in accounting and finance and should be alarmed at the quality of auditing and financial reporting.

3. Bearing in mind the above suggestions, BAPEPAM-LK as the capital market watch dog in Indonesia should initiate regulations that lift the standard of audit quality and corporate governance implementation among listed companies. With regard to promoting confidence in the quality and reliability of audited financial statements in Indonesia, a Committee on Public Accountant Profession (*Komite Profesi Akuntan Publik*) as mandated by PA Law 2011 should be established in line with global trends of putting in place an effective audit oversight body in the country (e.g. PCAOB in the US, Company Auditors & Liquidators Disciplinary Board of ASIC in Australia, and the Audit Oversight Board (AOB) in Malaysia, to name a few).

Furthermore, regarding governance practices, BAPEPAM-LK or IDX should required listed companies to have a majority of independent (outside) commissioners, rather than only 30% as required by the current listing rules. Moreover, there is an urgent need to require a continuing education and training for company commissioners or directors to ensure their financial literacy for reading and understanding fundamental financial statements. As the Code for Corporate Governance in Indonesia is fully voluntary and does not constitute regulation, BAPEPAM-LK and IDX need to further specify corporate governance regulations, including ensuring that effective supervision and monitoring shall performed by boards of commissioners and their audit committees, and also to make more accountable boards of directors (management boards).

#### **7.4 Limitations of the study**

Finally, a number of important limitations need to be considered. The limitation lies in the fact that there is a potential for misclassification. The BAPEPAM-LK only releases some cases of their enforcement actions and, in turn, the complete details of cases are unknown. The inclusion of 78 firms with accounting irregularities is a strong reliable source of data because BAPEPAM-LK is the sole Indonesian market authority to impose the administrative sanctions based on the country's capital market rules.

However, the matching process of another 78 listed firms within the same size and industry cannot be taken to automatically imply that all other companies do not commit accounting irregularities. Unknowingly including such companies as non-committing of accounting irregularities could bias the findings, again to the some extent limiting the generalisation of the findings to the population.

Furthermore, as mentioned earlier in subsection 6.2, the quantity and thoroughness of information in annual reports creates another limitation of the quality of variable measurement. This present study does not incorporate some important variables of corporate governance mechanisms which it is not mandatory for firms to provide as public disclosure. The details of this information could be helpful in determining the effectiveness of corporate governance mechanisms. An example of such information is the number of meetings conducted by the BOC and their audit committee, information which has been retained by the issuers. To a large extent, this has impacted on the ability to infer the significance of audit committee effectiveness and, in turn, limited the value able to be generated from interpreting the findings of this governance dimension.

Finally, a scoring measurement of corporate governance is always vulnerable to subjectivity. Some variables cannot be measured by the existing information in the firms' annual reports; the measurement of such variables is based on particular criteria (see chapter 5 for the measurements used). Despite the fact that there was a documentation of the research processes, this kind of measurement could be subjective and, to some extent, biased by the researcher's point of view.

## **7.5 Suggestions for future research**

This study is a quantitative study that has examined all dimensions of Indonesian corporate governance and their effectiveness in curbing the likelihood of serious misstatements. This current study has thrown up many questions in need of further examination. Therefore, it is suggested that further study be undertaken in the following areas:

1. More information on details of the sanctions imposed by BAPEPAM-LK would help to reduce the risk of misclassification of sample selections. Future trials should incorporate the possibility of accessing the list of cases that have been handled by

the Enforcement Bureau of BAPEPAM-LK or other similar enforcement bodies. BAPEPAM-LK only mentions some cases in their annual report – typically those that are already known by public or featured in the mass media. The remaining cases are confidentially kept by the office and not disclosed to the public. It might be that BAPEPAM-LK wanted to limit the market reaction; disciplinary actions are only for issuers' administrative reprimands. In most other cases, these data has been made publicly available (for example: the AAERs of the US SEC, the shame list of issuers in default of Canadian SEC and the EUs of ASIC in Australia).

2. Although earlier studies have shown that increasing the effectiveness of boards of directors (similar to boards of commissioners within this study) and their audit committees reduces the likelihood of serious accounting irregularities, the empirical evidence of the variables provided by this current study indicates that no such association exists. This contradiction in findings suggest that perhaps the general functioning of boards of commissioners and their audit committees in Indonesia are simply to meet the listing requirements, without really discharging their duties to mitigate the agency problem they must address (World Bank 2010). Conceivably, an in-depth interview approach or the inclusion of qualitative attributes to figure out the other aspects within the boards of commissioners and audit committees could determine the effectiveness of these supervisory and monitoring bodies.
3. An additional area worthy of further study is to exploit the positive benefits of having full independent commissioners of a board of commissioners. In Indonesia, the current requirement of at least 30% of board members as independent commissioners is not in line with the spirit of providing an effective framework for supervision and monitoring over listed companies due to “grey” area directors (Vicknair, Hickman & Carnes 1993) being the majority on boards of commissioners. The positive effect of a majority or perhaps full independence of all members is already known. Therefore, a study based on a hypothesis of this requirement would be useful to regulators to provide evidence as to whether or not the increase is needed.
4. Another line of research can also be developed to examine the effect of conservative accounting practice and tendencies for political connections dealing with accounting irregularities. Since many analysts now argue that firms are allegedly more at risk in

publishing financial statements with error or fraud when they adopt aggressive accounting and have political connections, it would be useful to examine both additional variables in relation to the misreporting performed by issuers.

5. Other studies that examine companies under similar legislation, particularly in emerging countries, would be valuable.

## **7.6 Concluding statement**

This chapter concludes the main findings of the thesis. This thesis adds to the growing body of international literature on ensuring the role of corporate governance in curbing accounting scandals. From a practical perspective, the current study provides feedback to Indonesia's policymakers and corporate governance regulators on the important need to lift the standards in implementing corporate governance and for guidelines that support effective corporate governance (i.e. supervisory boards and their committees, management boards, and auditor quality). The results also contribute to the current debate on the advantages and disadvantages of the two-tier board system. After all, this study is expected to provide useful information to Indonesian listed firms, and other contexts with similar legislation, in terms of having high-quality teamwork among effective corporate governance mechanisms.



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## Appendix A: Covering letter for data collection



3 November 2010

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**Pusat Referensi Pasar Modal (PRPM)**  
**Capital Market Reference Centre**  
**Indonesian Stock Exchange**

Re: Data Collection (Jaswadi)

Dear Sir,

I am conducting research entitled '*Investigating Corporate Governance and Accounting Irregularities in Indonesia*' of some companies listed on the Indonesian Stock Exchange (IDX) as part of my Doctor of Business Administration program under supervision of Dr. Nick Billington and Dr. Stella Sofocleous.

My research aim is to investigate the influence of individual corporate governance dimensions and corporate governance as a system on the likelihood of accounting irregularities occurring in Indonesia. This research will empirically develop a model to explain why some companies succumb to certain degrees of accounting irregularities whereas others do not, by examining the BAPEPAM - LK's enforcement actions as published in its annual report. This research project has been approved by the Faculty of Business and Law Postgraduate Committee.

As the research spans the period from 2000 to 2009, I would like to request your help in accessing listed companies' annual reports at the Capital Market Reference Centre. I am going to visit PRPM in Jakarta on Monday 15 November 2010 till the beginning of December 2010.

One of these research outcomes is expected to uncover factors where IDX and BAPEPAM-LK need to take a closer look in reducing the likelihood a listed company submits fraudulent financial reporting. Should you have any queries about this research please contact my principal supervisor Dr. Nick Billington, or myself on the details of which are below.

Thank you very much for your participation.

Yours Sincerely,

[Redacted Signature]  
Jaswadi  
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Victoria Graduate School of Business  
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**Dr. Djonieri**

International Affairs and Public Relations Division  
BAPEPAM – LK  
Ministry of Finance Republic of Indonesia

Re: Research Visit (Jaswadi)

Dear Sir,

I am conducting research entitled '**Investigating Corporate Governance and Accounting Irregularities in Indonesia**' on the Indonesian Stock Exchange (IDX) as part of my Doctor of Business Administration program under supervision of Dr. Nick Billington and Dr. Stella Sofocleous.

My research aim is to investigate the influence of individual corporate governance dimensions and corporate governance as a system on the likelihood of accounting irregularities occurring in Indonesia. This research will empirically develop a model to explain why some companies succumb to certain degrees of accounting irregularities whereas others do not, by examining the BAPEPAM - LK's enforcement actions as published in its annual report. This research project has been approved by the Faculty of Business and Law Postgraduate Committee.

I would like to request your insight as policy makers to what is currently BAPEPAM-LK concern to reduce the likelihood a listed company submitted fraudulent financial reporting either to the Indonesian stock market or BAPEPAM-LK. I will be in Jakarta between 13 November and the beginning of December 2010.

Should you have any queries about this research please contact my principal supervisor Dr. Nick Billington, or myself on the details of which are below.

Thank you very much for your participation.

Yours Sincerely,

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## Appendix B: Summary of cases handled by BAPEPAM-LK

Year	Number of issuers with sanctions			
	warned	fined	investigated	prosecuted
1999	4	187	0	1
2000	0	164	39	3
2001	108	130	44	2
2002	4	186	44	2
2003	0	121	0	N/A
2004	0	315	51	2
2005	0	160	36	3
2006	0	140	16	6
2007	0	136	39	15
2008	1	212	67	15
2009	14	288	121	11
Average	12	185	42	6

Source: BAPEPAM-LK's annual reports (2000 - 2009)



## Appendix C: List of samples and matched samples

No	Year	Samples		LAI	IND	SIZE	Matched Sample		LAI	IND	SIZE
		Code	Company Name				Code	Company Name			
1	2000	LPLI	PT. Lippo e-Net, Tbk (Now Star Pacific, Tbk)	3	84	781,000,000,000	PNLF	PT. Panin Life, Tbk	0	84	1,903,000,000,000
2	2001	SMAR	PT. SMART Corporation, Tbk	3	51	3,570,000,000,000	RMBA	PT. Bentoel International Investama, Tbk	0	52	2,073,000,000,000
3		INKP	PT. Indah Kiat Pulp & Paper, Tbk	3	38	50,430,470,787,000	FASW	PT. Fajar Surya Wisesa, Tbk	0	38	2,627,000,000,000
4		TKIM	PT. Tjiwi Kimia, Tbk	3	38	17,893,000,000,000	SAIP	PT. Surabaya Agung Industry Pulp, Tbk	0	38	2,324,000,000,000
5		SMMA	PT. Sinar Mas Multiartha, Tbk	3	89	745,000,000,000	MKDO	PT. Makindo, Tbk	0	89	964,000,000,000
6	2002	BMTR	PT. Bimantara Citra, Tbk (now Global Mediacom)	2	98	4,010,000,000,000	BNBR	PT. Bakrie and Brothers, Tbk	0	98	5,202,000,000,000
7		JSPT	PT. Jakarta Setiabudi International, Tbk	2	94	1,800,000,000,000	PLIN	PT. Plasa Indonesia Realty, Tbk	0	94	1,731,000,000,000
8		BLTA	PT. Berlian Laju Tanker, Tbk	2	74	2,591,000,000,000	HITS	PT. Humpus Intermoda Transportasi, Tbk	0	74	2,168,000,000,000
9		PAFI	PT. Panasia Filament Inti, Tbk	2	43	781,000,000,000	SSTM	PT. Sunson Textile Manufacturer, Tbk	0	43	812,000,000,000
10		HDTX	PT. Panasia Indosyntec, Tbk	2	43	2,010,000,000,000	ARGO	PT. Argo Pantes, Tbk	0	43	2,335,000,000,000
11		IMAS	PT. Indomobil Sukses International, Tbk	2	42	2,303,000,000,000	AUTO	PT. Astra Otopart, Tbk	0	42	1,832,000,000,000
12		PGIN	PT. Procter & Gamble, Tbk	2	54	135,000,000,000	MRAT	PT. Mustika Ratu, Tbk	0	54	292,000,000,000
13		SMAR	PT. Smart Corporation, Tbk	2	51	3,570,086,000,000	ULTJ	PT. Ultra Jaya Milk, Tbk	0	51	1,018,000,000,000
14		KAEF	PT. Kimia Farma, Tbk	3	53	1,039,000,000,000	KLBF	PT. Kalbe Farma, Tbk	0	53	2,016,000,000,000
15		BUMI	PT. Bumi Resources, Tbk	2	22	3,687,000,000,000	MEDC	PT. Medco Energi International, Tbk	0	22	6,706,000,000,000
16		JPRS	PT. Jaya Pari Steel, Tbk	2	33	127,000,000,000	LION	PT. Lion Metal Works, Tbk	0	33	108,000,000,000
17		MYRX	PT. Hanson Industri Utama, Tbk (dh. Mayertex Ind)	2	43	656,000,000,000	ESTI	PT. Ever Shine Textile Industry, Tbk	0	43	665,000,000,000
18		SIMA	PT. Siwani Makmur, Tbk	2	35	80,000,000,000	PLAS	PT. Plastpack Prima Industri, Tbk	0	35	83,000,000,000
19		MYOR	PT. Mayora Indah, Tbk	2	51	1,332,000,000,000	TBLA	PT. Tunas Baru Lampung, Tbk	0	51	1,022,000,000,000
20		MLPL	PT. Multipolar Corporation, Tbk	2	97	1,772,000,000,000	SCMA	PT. Surya Citra Media, Tbk	0	97	1,827,398,000,000
21		ASII	PT. Astra International, Tbk	2	42	26,186,000,000,000	GJTL	PT. Gajah Tunggal, Tbk	0	42	12,444,164,000,000
22		SMGR	PT. Semen Gresik (Indicated in 2003)	2	31	7,040,000,000,000	SMCB	PT. Semen Cibinong, Tbk	0	31	7,714,000,000,000

(To be continued)

Appendix C: (Continued)

No	Year	Samples		LAI	IND	SIZE	Matched Sample		LAI	IND	SIZE
		Code	Company Name				Code	Company Name			
23	2003	GRIV	PT. Great River International, Tbk	2	93	1,122,000,000,000	HERO	PT. Hero Supermarket, Tbk	0	93	1,124,000,000,000
24		SMDM	PT. Suryamas Dutamakmur, Tbk	2	61	1,997,000,000,000	DILD	PT. Dharmala Intiland, Tbk	0	61	1,808,000,000,000
25		DAVO	PT. Davomas Abadi, Tbk	2	51	894,000,000,000	SHDA	PT. Sari Husada, Tbk	0	51	1,121,000,000,000
26		DOID	PT. Daeyu Orchid Indonesia, Tbk (Now Delta Dunia Raya)	2	43	40,096,243,408	SRSN	PT. Sarasa Nugraha, Tbk	0	43	139,000,000,000
27		DYNA	PT. Dynaplast, Tbk	2	35	767,000,000,000	AKPI	PT. Argha Karya Prima Industri, Tbk	0	35	1,355,000,000,000
28		GDWU	PT. Kasogi International, Tbk	2	44	96,000,000,000	BIMA	PT. Primarindo Asia Infrastructure, Tbk	0	44	83,000,000,000
29		CNKO	PT. Central Corporindo International	3	24	242,000,000,000	CTTH	PT. Citatah, Tbk	0	24	279,000,000,000
30		LPBN	PT. Bank Lippo, Tbk	3	81	26,466,000,000,000	BNGA	PT. Bank Niaga, Tbk	0	81	23,749,000,000,000
31		BBLD	PT. BBL Dharmala Finance, Tbk (Bina Danatama Finance)	3	82	971,000,000,000	BFIN	PT. BFI Finance Indonesia, Tbk	0	82	1,126,000,000,000
32		HADE	PT. Hortus Danavest, Tbk (Now HD Capital)	2	83	69,000,000,000	YULI	PT. Yulie Securindo, Tbk	0	83	58,000,000,000
33	2004	INDX	PT. Indoexchange Tbk	2	97	13,000,000,000	ITTG	PT. Integrasi Teknologi, Tbk	0	97	17,000,000,000
34		DOID	PT. Daeyu Orchid Indonesia, Tbk (Now Delta Dunia Raya)	2	43	830,000,000,000	SSTM	PT. Sunson Textile Manufacturer, Tbk	0	43	924,000,000,000
35		DAVO	PT. Davomas Abadi, Tbk	2	51	1,578,000,000,000	TBLA	PT. Tunas Baru Lampung, Tbk	0	51	1,352,000,000,000
36		INAF	PT. Indofarma, Tbk	2	53	524,000,000,000	DVLA	PT. Darya-Varia Laboratoria, Tbk	0	53	431,000,000,000
37		BGIN	PT. Bank Global International, Tbk	2	81	1,848,000,000,000	BKSW	PT. Bank Kesawan, Tbk	0	81	1,534,000,000,000
38	2005	PSDN	PT. Prasidha Aneka Niaga, Tbk	2	51	284,000,000,000	ADES	PT. Ades Water Indonesia, Tbk	0	51	210,000,000,000
39		PLAS	PT. Palm Asia Corpora, Tbk	2	98	237,000,000,000	ASGR	PT. Astra Graphia, Tbk	0	97	519,000,000,000
40		SHDA	PT. Sari Husada, Tbk	2	51	1,087,000,000,000	ULTJ	PT. Ultra Jaya Milk, Tbk	0	51	1,254,000,000,000
41		INKP	PT. Indah Kiat Pulp, Tbk	2	38	51,617,000,000,000	SAIP	PT. Surabaya Agung Industry Pulp, Tbk	0	38	2,122,000,000,000
42		SMMA	PT. Pabrik Kertas Tjiwi Kimia, Tbk	2	38	20,709,000,000,000	FASW	PT. Fajar Surya Wisesa, Tbk	0	38	2,882,000,000,000
43		KREN	PT. Kresna Graha Securindo, Tbk	2	83	165,000,000,000	PEGE	PT. Panca Global Securities, Tbk	0	83	158,000,000,000
44	2006	TRST	PT. Trias Sentosa, Tbk	2	35	2,020,000,000,000	AKPI	PT. Argha Karya Prima Indonesia, Tbk	0	35	1,460,000,000,000
45		SUDI	PT. Surya Dumai Industri, Tbk	2	37	568,000,000,000	TIRT	PT. Tirta Mahakam Resources, Tbk	0	37	570,000,000,000
46		WOMF	PT. Wahana Ottomitra Multiartha, Tbk	2	82	4,845,000,000,000	ADMF	PT. Adira Dinamika Multi Finance, Tbk	0	82	2,907,000,000,000
47		UNIT	PT. United Capital Indonesia, Tbk	2	83	121,000,000,000	AKSI	PT. Asia Kapitalindo Securities, Tbk	0	83	115,000,000,000
48		ZBRA	PT. Zebra Nusantara, Tbk	2	74	119,000,000,000	CMPP	PT. Centris Multi Persada Pratama, Tbk	0	74	149,000,000,000
49		SING	PT. Singer Indonesia, Tbk	2	91	8,839,000,000	INTD	PT. Inter-Delta, Tbk	0	91	28,000,000,000
50		BKSL	PT. Bukit Sentul, Tbk	3	61	2,636,000,000,000	ELTY	PT. Bakrieland Development, Tbk	0	61	2,396,000,000,000
51		BVIC	PT. Bank Victoria, Tbk	3	81	2,896,000,000,000	BKSW	PT. Bank Kesawan, Tbk	0	81	2,052,000,000,000
52		MEGA	PT. Bank Mega, Tbk	3	81	30,973,000,000,000	BBKP	PT. Bank Bukopin, Tbk	0	81	31,556,000,000,000



Appendix C: (Continued)

No	Year	Samples		LAI	IND	SIZE	Matched Sample		LAI	IND	SIZE
		Code	Company Name				Code	Company Name			
53	2007	MEGA	PT. Bank Mega, Tbk	2	81	34,908,000,000,000	BBKP	PT. Bank Bukopin, Tbk	0	81	34,446,000,000,000
54		SUGI	PT. Sugi Samapersada, Tbk	2	91	50,033,000,000	KONI	PT. Perdana Bangun Pusaka, Tbk	0	91	63,000,000,000
55		MYOH	PT. Myoh Technology, Tbk	2	97	9,510,000,000	DNET	PT. Dyviacom Intrabumi, Tbk	0	97	23,000,000,000
56		SSIA	PT. Surya Semesta Internusa, Tbk	2	62	1,541,000,000,000	TOTL	PT. Total Bangun Persada, Tbk	0	62	1,306,000,000,000
57		DKFT	PT. Duta Kirana Finance, Tbk (Now Central Omega	2	82	36,000,000,000	INCF	PT. Indocitra Finance, Tbk	0	82	42,000,000,000
58		WIKA	PT. Wijaya Karya, Tbk	2	62	4,133,000,000,000	TRUB	PT. Truba Alam Manunggal Engineering, Tbk	0	62	4,991,000,000,000
59		PSKT	PT. Pusako Tarinka, Tbk	2	94	26,000,000,000	PSAB	PT. Pelita Sejahtera Abadi, Tbk	0	94	12,000,000,000
60		MTSM	PT. Metro Supermarket Realty, Tbk	2	93	99,000,000,000	TKGA	PT. Toko Gunung Agung, Tbk	0	93	89,000,000,000
61		GMCW	PT. Grahamas Citra Wisata, Tbk	2	94	21,000,000,000	SMMT	PT. Eatertainment International, Tbk	0	94	21,000,000,000
62		UNTX	PT. Unitex, Tbk	2	43	151,000,000,000	ESTI	PT. Ever Shine Textile Industry, Tbk	0	43	518,857,000,000
63		SING	PT. Singer Indonesia, Tbk (Now Singleterra, Tbk)	2	91	7,000,000,000	INTD	PT. Inter-Delta, Tbk	0	91	24,000,000,000
64		TPMI	PT. Agis, Tbk	3	91	704,000,000,000	META	PT. Nusantara Infrastructure, Tbk	0	91	650,000,000,000
65		PNBN	PT. Pan Indonesia Bank, Tbk	3	81	53,471,000,000,000	BNGA	PT. Bank Niaga, Tbk	0	81	54,886,000,000,000
66		WICO	PT. Wicaksana Overseas International, Tbk	2	91	228,000,000,000	TIRA	PT. Tira Austinite, Tbk	0	91	228,581,000,000
67		GMCW	PT. Grahamas Citra Wisata, Tbk	2	94	20,952,000,000	ICON	PT. Island Concept Indonesia, Tbk	0	94	14,086,000,000
68	2008	CKRA	PT. Citra Kebun Raya Agri, Tbk	2	61	1,288,000,000,000	GPRA	PT. Perdana Gapuraprima	0	61	1,409,000,000,000
69		AISA	PT. Tiga Pilar Sejahtera Food, Tbk	2	51	1,017,000,000,000	ULTJ	PT. Ultra Jaya Milk, Tbk	0	51	1,741,000,000,000
70		IATG	PT. Infoasia Teknologi Global, Tbk	2	73	383,107,000,000	IATA	PT. Indonesia Air Transport, Tbk	0	74	604,000,000,000
71		BCIC	PT. Bank Century, Tbk	3	81	14,509,632,000,000	MAYA	PT. Bank Mayapada International	0	81	5,513,000,000,000
72		DSFI	PT. Dharma Samudra Fishing Industries, Tbk	2	14	139,000,000,000	IIKP	PT. Inti Agri Resources, Tbk	0	14	413,129,000,000
73	2009	BBLD	PT. Buana Finance, Tbk	2	82	1,370,730,188,537	CFIN	PT. Clipan Finance Indonesia, Tbk	0	82	1,771,000,000,000
74		BEKS	PT. Bank Executive International, Tbk	2	81	1,426,000,000,000	BSWD	PT. Bank Swadesi, Tbk	0	81	1,537,000,000,000
75		BIPP	PT. Bhuwantala Indah Permai, Tbk	2	61	195,000,000,000	LCGP	PT. Laguna Cipta Griya, Tbk	0	61	181,903,000,000
76		TPMI	PT. Agis, Tbk	2	91	1,379,000,000,000	TGKA	PT. Tigaraksa Satria, Tbk	0	91	1,466,000,000,000
77		ERTX	PT. Eratex Djaja, Tbk	2	43	97,000,000,000	KARW	PT. Karwell Indonesia, Tbk	0	43	102,000,000,000
78		RINA	PT. Katarina Utama	3	75	105,104,353,462	WEHA	PT. Panorama Transportasi, Tbk	0	74	155,000,000,000

Source: BAPEPAM-LK's annual report (2000 – 2009)