

The Role Corporate Governance on Financial Reporting's Quality (Evidence from Indonesia Stock Exchange)

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Abstract

After IFRS implementation in Indonesia on 2012, there is no significant evidence about improvement financial reporting quality. Many theories explained that the role of corporate governance mechanism in IFRS implementation improve financial reporting quality. This research aims to investigate the role of corporate governance mechanism on the improvement of financial reporting quality. Empirical analysis uses survey method with the site objects are 33 Non-Financial Sectors Emiten at Indonesia Stock Exchange. The descriptive analysis and path analysis have been used to analyze the data and tested the hypothesis by using Software Lisrel 8.70. The result of this research shows that the quality of audit committee and audit internal has significant effect on the financial reporting quality. The quality of audit committee and internal audit has big contribution to increase financial reporting quality. The result of this research confirmed with the corporate governance concept, that internalization of good corporate governance principles are proven in increasing transparency, accountability and timeliness of financial statement in corporations.

Keywords: corporate governance, financial reporting quality

1. Introduction

From 2009, Indonesia has done a gradual IFRS convergence and its full implementation is planned to be from 2012. To make the materials meet IFRS standard, The Standard Finance Accounting Council from Indonesian Accounting Association (Dewan Standar Akuntansi keuangan Ikatan Akuntan Indonesia or DSAK-IAI) has revised some Finance Accounting Standard Statements (Pernyataan Standar Akuntansi Keuangan PSAK). IFRS convergence to PSAK is expected to increase the quality of financial reporting of internationally known Indonesian companies.

IFRS implementation requires high quality from all stake holders including corporate governance mechanism support. Inside the corporate governance mechanism, audit and internal audit committee has to ensure the integrity and reliability of the financial reporting, ensure the obedience of company towards rules and regulations including IFRS implementation (Rezaee dan Riley, 2010:124; Rezaee 2003; Ahmadi Hadibroto, 2009; Keputusan Bapepam dan Lembaga Keuangan Nomor Kep-643/BL/2012)

Corporate governance mechanism affects financial information quality (Klai and Omri 2011), and could as well be the obstacle of earning management (Chtourou et al 2001). The role and function of good corporate governance is to increase financial information quality. Based on several research reveal that audit committee has significant effect on financial reporting quality, Baxter BBus (2007) stated that a significant decrease of earning management could be observed after audit committee forming, and audit committee forming could increase financial reporting quality.

Independency and activity of audit committee have negative significant relationship with restatements of financial reporting (Abbott et al 2004), audit committee's independency has negative relationship on abnormal accrual (Krishnamoorthy, 2002) and abnormal accrual, (klein, 2002). The size and percentage of audit committee's member possessing knowledge on accounting and financial management have positive relation in the quality of financial reporting (Felo et al, 2003).

The corporate governance development revolution in a numbers of countries shows the importance of internal audit to enhance the transparency and quality of financial reporting (Al-Shetwi et al 2011). The internal audit function quality has negative effect on earning management. A company with good internal audit function quality could decrease accrual abnormality. In a bigger perspective we could also see the important roles of internal auditor function in external financial reporting (Prawit, Smith and Wood, 2009). Internal auditor would be sensitive when management incentive report financial statements mistakenly and it would also increase working hours when the management has high incentive to give false financial report (Asare et al, 2008; Prawit, Smith and Wood, 2009).

Even though many research has been conducted to test the role of corporate governance towards financial reporting quality, only few has done research towards the resulting role after the implementation of International Financial Reporting Standard. This research purpose is to test whether audit committee and internal committee quality plays role in increasing the quality of financial reporting after IFRS implementation in some companies with high accountability in Indonesia. The research was done using survey method, airmail

questionnaire, and direct questionnaire for audit committee and non-listed non-financial companies internal audit committee in Indonesian Stock Exchange 2013.

2. Literature Review

2.1 Corporate Governance and Financial Reporting Quality

The quality of financial reporting could be measured in two perspectives as mentioned below: (1) based on user needs and (2) based on protection towards shareholders/ investor. The financial information usage determines the reporting quality in the first perspective. This approach is adopted from the basic formation of financial statement as to give beneficial information towards user especially for their decision making.

The second perspective focuses on the idea of shareholder/investor protection. This perspective defines financial reporting quality as the reporting and transparency of financial information that should not mislead the information user (Jonas and Blanchet, 2000).

The quality of financial reporting is related with good corporate governance mechanism. The principal internalization of good corporate governance can support the company to do more professional, transparent, effective, and efficient management of their company (Suprayitno 2005). The role and function of corporate governance are to enhance the quality of financial information, (Rezaee, 2003; Institute of Internal Auditors, 2011) thus the role of audit committee and internal audit committee are crucial in the practical aspect of corporate governance especially their openness and the quality of financial reporting (Rezaee dan Riley, 2010: 124; Rezaee, 2003; Institute of Internal Auditors, 2005a).

Audit committee is related to the quality of financial statements (I Nyoman Tjager dkk 2003:34; Elder et al, 2010: 114; KNGCG, 2002). The Audit committee could help board of commissioner to do their role of supervising management financial reporting. Strengthening audit committee is one of the way to increase financial reporting integrity and quality (Artur Levitt, 1998)

The previous research showed that audit committee has crucial role towards financial reporting quality. The significant decrease of earning management in the year when audit committee was formed (Baxter BBus, 2007), independency and audit committee activity have negative significant relationship towards restating of financial statements and also decrease the abnormal return (Abbott et al 2004 : Klein 2002). The size and percentage of audit committee member possessing accounting and financial management expertise have positive relationship with the financial reporting quality (Felo et al, 2003; Krishnamoorthy, 2002). Based on the above statements, we proposed the first hypothesis:

Audit committee influence the increase of financial reporting quality.

2.1 The Influence of Internal Audit on Financial Reporting Quality

Internal audit profession has grown significantly after the biggest accounting scandal had happened. Internal audit became the best way to enhance company operation, risk management control, and also company management (Dana R. Hermanson et al 2008). Internal audit is expected to create supervising mechanism by doing various test and marking for financial, accounting and other operation activity's efficiency (Al-shetwi et al 2011).

Some research result showed that internal audit function is related to the increase of financial reporting quality (Al-shetwi et al 2011). Internal audit quality function has a negative relation towards earning management. Company with good internal audit quality function will have decreased abnormal accrual value (Prawit, Smith and Wood, 2009). Effective internal audit function can prevent aggressive financial reporting. (Schneider and Wilner, 1990). Internal auditor would be sensitive when management incentive report financial statements mistakenly and it would also increase working hours when the management has high incentive to give false financial report. (Asare et al 2008; Prawit et al 2009). Based on the above statements, we proposed the second hypothesis:

Internal audit influence the increase of financial reporting quality.

3. Data and Research Design

All listed companies in Indonesian Stock Exchange are considered to be the study population (www.idx.com) and the population target is all listed non-financial companies in Indonesian Stock Exchange 2013. 74 companies were determined using simple random sampling method. Data collecting was done with survey method using airmail and direct questionnaire. Out of 100 copies sent only 33 was sent back, making the respond rate to be 33%.

3.1 Measurement of Corporate Governance

Audit committee and internal audit was two of corporate governance mechanisms that were adopted to measure the quality of corporate governance (Rezaee dan Riley, 2010: 124; Rezaee 2003; Institute of Internal Auditors 2011; Keputusan Bapepam dan Lembaga Keuangan Nomor 643/BL/2012; Keputusan Bapepam dan Lembaga

Keuangan Nomor No. 496/2008), while the quality of financial reporting was measured using FASB Conceptual Framework.

The measurement of independent and dependent variable to test the hypothesis are explained in table 1 below:

Table: Measurement of Variable

Variable	Dimension	Indicator
Audit Committee	Audit Committee Qualification	1. Independency, Objectivity 2. Has adequate integrity, skill, and experience 3. Has accounting and finance skill
	Audit Committee Authority	1. To observe financial statements integrity 2. To supervise obedience towards regulation 3. To supervise the qualification, independency, and effectiveness of internal and external audit.
	Audit Committee Resource	1. The number of audit committee 2. The number of independent audit committee
Internal Audit	Task Scope of Internal Audit	1. To ensure regulation fulfillment and the accuracy of reporting to regulator. 2. To ensure the precision and accuracy of accounting data and financial statements.
	Internal Audit Characterization	1. Independency and objectivity 2. Owning professional expertise and accuracy 3. Owning internal audit charter
Financial Statements Quality	Timeliness	1. Yearly financial statement delivery date to Bapepam 2. The opinion of Financial Statements

4. Empirical Result

Data analysis to test the hypothesis was done using description analysis and path analysis with the assistance of Lisrel 8.70 Software. The research result is formulated in this path diagram below:

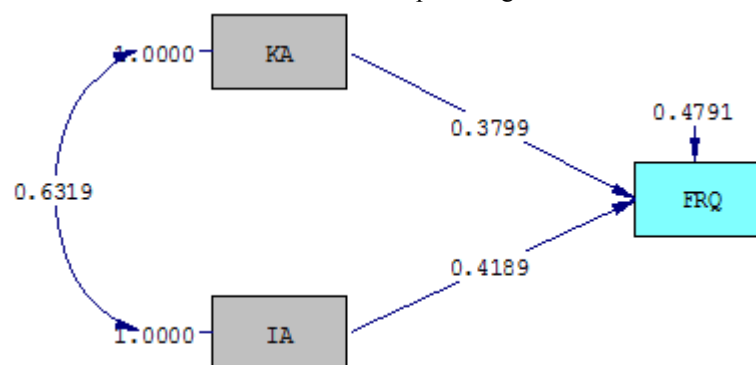


Figure 1: Path Diagram of Hypothesis Testing

From the diagram above, it could be concluded that statistically audit committee could affect financial reporting quality significantly. This test gave empirical evidence that as the function quality of audit committee gets better the financial reporting quality will also get better. Audit committee affects financial reporting quality by 14,43%, while the indirect effect through audit committee and internal audit is 10,06% and total effect of 24,49%.

The result of this research is relevant and also supports the theory of audit committee role in financial reporting quality enhancement (Elder et al 2010: 114; Rezaee and Riley, 2010: 124; Rezaee, 2003). It also supports the research of Felo et al (2003) and Abbott et al (2004), these research stated the number of audit committee member possessing accounting and finance management expertise would have positive effect to financial reporting quality.

The research also shows that internal audit also has correlation with the accuracy of financial reporting, as shown by the average value of internal audit task of 3,65% whereas most respondents assume that internal audit has confirmed the accuracy of financial statements and their involvement in IFRS implementation process by 51,5% 57,5% and even 63,6% .

This research also supports (Prawit, Smith and Wood 2009; Al-shetwi et al, 2011) study, stating that companies with high quality internal audit function could decrease opportunistic manager behavior. The

presence of internal audit could create supervising mechanism by doing efficiency and effectiveness test and measurement of finance and accounting.

The institutional environment of Indonesian Stock Exchange shows that the function quality of internal audit has significant effect towards financial reporting quality. All listed companies inside Indonesian Stock Exchange have to follow the regulation made by the head of BAPEPAM LK (Number : KEP-496/BL/2008) in line with Attribute Standard 1000, *International Standards for the Professional Practice of Internal Auditing* (Institute of Internal Auditors, 2011) about guidelines of internal audit unit charter. All tasks and responsibilities of internal audit have to be stated formally by Internal Audit Charter.

According to most respondents respond, the majority of companies already have adequate internal audit charter, shown by 63,6% of respondent's responses and the availability of already implemented internal audit charter according to the needs and accountability of internal audit. Most of the listed companies in Indonesian Stock Exchange already have internal audit charter consists of the role and responsibility, authority, ethical code, and accountability of internal audit unit.

5. Conclusion

The quality of audit committee and internal audit has significant effect towards financial reporting quality. This shows that the more quality and function audit committee have the more precise financial reporting will be. The qualification, authority, and resource poses by audit committee could guarantee the precision financial statements reporting. The scope duties of internal audit committee will enhance the financial statement reporting and ensure regulation obedience, precision, and reliability of financial statements data.

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