

Corporate governance and Accounting irregularities: Evidence from the two-tiered board structure in indonesia

Jaswadi^{a*}
Nicholas Billington^b
Stella Sofocleous^c

^aSchool of Accounting, State Polytechnics of Malang, Indonesia; ^bSchool of Management and Information System, Victoria University, Melbourne, Australia; ^cSchool of Accounting and Finance, Victoria University, Melbourne, Australia

ABSTRACT

This study aims to investigate the role of Indonesian corporate governance as an effective tool for protecting financial statements users against accounting irregularities. Considering that accounting irregularities might occur in between error and the fraud act, this study reviews the literature on minimizing the seriousness of these reporting incidences. The paper is a replication of Smaili and Labelle (2009) in an Indonesian context. The financial misstatement, which is accounting irregularities, within two-tier board system is more severe when: (a) there is absence of financial expert(s) on supervisory boards and audit committees, (b) companies have short tenured-CEOs and poor internal control systems, and (c) auditors are solely appointed by firms' BOCs without agreement of block holders (known as referral). In addition, an examination of simultaneous effects of each corporate governance dimension reveals a general weakness of the BOCs and their audit committees. However, the BOC and audit committee could be an effective tool in mitigating reporting incidences, especially when they show high-quality collaboration.

Keywords: Indonesian Corporate governance, two-tiered board system, and accounting irregularities.

*Corresponding author. Email: jaswadi@live.vu.edu.au

Background

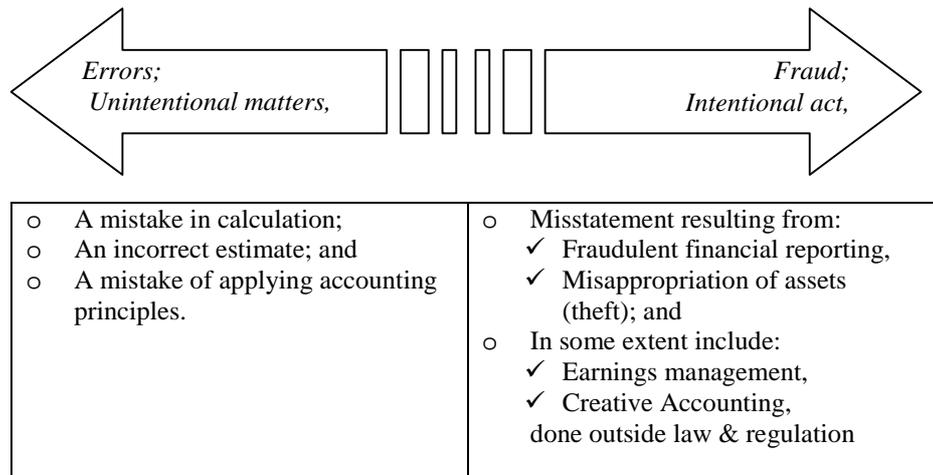
A number of financial scandals involving accounting irregularities, including misleading financial statements, have occurred in leading companies in the United States of America (the US) and other countries. For example, Enron and WorldCom presented misleading financial statements that defraud investors, to name but a few. Recently, the investing public was shocked by the newest post-Sarbanes-Oxley (SOX) cases including the 2008 US subprime mortgage and financial institution meltdown. Again, history repeated 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 have led investors, regulators and academics to try to find ways to reduce such incidences by improving certain dimensions of corporate governance and focusing on red flags in accounting scandals.

In finding ways to prevent the incidence of accounting scandals that lead to economic problems, many scholars have tried to develop a model to explain the corporate governance mechanism and its role in preventing those incidences (Abbott, Park, & Parker, 2000; Archambeault, 2000; Beasley, 1996; Bourke, 2007; Bourne, 2008; Chen, Firth, Gao, & Rui, 2006; Sanbeh, 2010; Smaili & Labelle, 2009). These new ideas include: increasing the number and role of independent directors; eliminating Chairman-CEO dualities; and promoting collaboration among governance mechanisms.

Much of the literature shows that incidences of financial misstatement are

frequently associated with corporate governance ineffectiveness. However, corporate governance studies have been largely undertaken in one-tier board systems which include a single Board of Directors (BOD). This means research outcomes are difficult to apply in other circumstances, such as two-tier board systems which include a Board of Commissioners (BOC) and a Board of Management where the system separates entirely chairman-CEO dualities (Djonieri, 2010). Thus, the relationship between corporate governance mechanisms and incidences of accounting scandals such as fraudulent financial reporting in two-tier board systems, cannot be applied using literature from one-tier board systems. A similar study by Smaili and Labelle (2009) was done in a Canadian one-tier board system; an investigation of corporate governance dimensions is needed to extend their findings into a two-tier board system. This study replicates their research in some ways and applied to the Indonesian context.

Previous research on accounting irregularities has concentrated on one type of irregularity at a time (Abbott, et al., 2000; Beasley, 1996), and only classified the incidence of accounting irregularities, not the gravity of these incidences. Therefore, it is crucial to identify the level of the misstatement instead of classifying them as a similar incidence (Smaili & Labelle, 2009). Accounting irregularities appear across an error–fraud continuum. 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 (see Figure 1).

Figure 1: Spectrum of Accounting Irregularities

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

In order to gain more insight into financial reporting practices in two-tier board systems, this paper will use the Indonesian setting that represents the specific environment. Indonesia requires a supervisory board (the BOC) which has responsibility to monitor and advise a board of management (also called the Board of Directors). The BOC is similar to the non-executive board of directors in a unitary board system. Within this system, the board of management leads the company and makes strategic and operational decisions. Thus, the BOC – not the Board of Directors – 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. In Asia, Japan and China also employ a similar board system. Even though previous research in governance has been done in a similar institutional setting, there is limited understanding that explains the relationship between governance mechanisms and the level of misstatement in this board system.

This study uses Indonesian Capital Market Supervisory Agency (known as BAPEPAM) law enforcement data to determine which governance dimensions might be used to predict the occurrence of accounting irregularities. As suggested by Smaili and Labelle (2009), the idea is

when the incidence is revealed by a market regulator, such as BAPEPAM; this indicates that the firm's governance mechanisms unable to avoid such a misleading financial statement.

The organization of the paper is as follows. First, an Indonesian legal framework of corporate governance and the financial reporting is presented. Second, previous research findings are reviewed to develop hypotheses. Third, samples and research method are outlined. Fourth, empirical analyses and discussion of findings are presented. Lastly, this paper summarises the results and proposes some suggestions for future improvement of corporate governance mechanisms.

Legal Framework And Financial Reporting System

Corporate governance in Indonesia

The nature of Indonesian corporate governance is not separated from its experience of the Dutch-legislation system. The existence of a two-tier board system is a characteristic of company organs in a civil law country. Much of the 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 (amendment of Company Law 1995), Capital Market Law 1995, and Investment Law 2007. The Company Law is considered as a centre of Indonesia's legal framework 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 the businesses in line with good corporate governance practices.

There are numerous studies exploring corporate governance practices both at macro and micro levels in Indonesia. However, a recent survey by Political and Economic Risk Consultancy (PERC) in 2010 also ranks Indonesia as the most corrupt of sixteen 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 crisis in Indonesia, contributing to its severity and length (Baird, 2000). Turning to the micro level, Lukviarman (2004) found that companies were characterized 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 BOC; (5) weak market control since only a relatively small percentage of company shares were 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 internalized, in public as well as corporate sectors.

In the case of implementing 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) stated that BAPEPAM and SROs (i.e. Indonesian Stock Exchange or IDX) supported by the WB and ADB have conducted some corporate governance projects including BAPEPAM'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. In 2001, IDX also required all listed firms to comply with corporate governance principles.

Since the Code development in 1999, Indonesia has improved its model of corporate governance. The NCCG also published guidelines for independent commissioners and audit committees in 2004. The NCCG has implemented the 2006 Code of corporate governance. A 2006 Code has been implemented as a revision of the 2001 Code. 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).

Financial reporting requirement in Indonesia

Development of the Indonesian accounting system is also as complex as Indonesian history. It has been developing since the appearance of the Dutch colonists, who used it to support their daily business bookkeeping. Subsequently, again after Independence in 1945, the system remained in use until adoption of US GAAP in 1973. Pressure on improving the accounting system has forced it away from

US GAAP to IFRSs in 1994. Financial reporting legislation governs Indonesian corporate disclosure. Listed companies are required by the Company Law and Capital Market Law to provide financial statements based on *Pernyataan Standard Akuntansi Keuangan* (PSAK/Indonesian Accounting Standards). PSAKs are mandatory for listed firms and business entities. The implementation is regulated by several government agencies (see Table 1) (ADB, 2003; Saudagaran & Diga, 2000).

Table 1: Key Financial Reporting Practices Laws and Regulatory

Regulations	Details
Company Registration 3/1982	This regulation requires company information being publicly accessible. Under the law, company must report their constitution details included authorised issued and paid-in capital to the Ministry of Trade & Industry upon their registration to be promulgated in State Gazette.
Pension Funds Law 11/1992	This law requires compulsorily Pension Funds to submit their audited financial statements to Minister of Finance (article 52 (1) (a)).
Banking Law 7/1992	According to article 34 (1, 2, and 3), Indonesian Central Bank or 'Bank Indonesia' requires banks to prepare audited financial statement on periodical basic according Bank Indonesia Regulations.
Capital Market Law 8/1995	Related to financial reporting, this law regulates mainly the preparation, presentation, and audit of financial statement. Law is supported by other BAPEPAM regulations that includes: <ul style="list-style-type: none"> - Generally accepted accounting principles (article 69 (1) and (2)); - Issuers and public company (Chapter IX); - Reporting and Information Disclosures (Chapter X);
Government Regulation 64/1999	This regulation amends on Government Regulation 24/1998 concerning company annual financial information. The regulation promulgated on October 13, 1999 reflected a significant improvement in encouraging company transparency. Previous regulation required listed company only to file audited financial statement, but the new rule enlarges limited liability company include: <ul style="list-style-type: none"> - Those are publicly listed; - Those are the nature of business-related mobilization of public funds; - Those issue debt instruments; - Companies has total assets at least Rp25billion; and - Debtors whose annual financial statement required by bank to be audited.
Ministry of Trading Decree 121/MPP/KEP/2/2002 on filing of a company's annual financial statement	This decree 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: <ul style="list-style-type: none"> • 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 are authorized to enter into agreements; and

	<ul style="list-style-type: none"> State-owned enterprises (SOEs) in the forms of <i>Persero</i>, <i>Perum</i> and <i>Perusahaan Daerah</i> (local government enterprise).
State-Owned Enterprises (SOEs) Law 19/2003	Article 23 (1) requires SOE's board of directors within 5 month of end of financial year to submit its annual report to shareholders' general meeting (GMS), which is government, to get the approval. In relation to this financial statement, GMS or Minister assign external auditor to conduct audit both <i>Persero</i> and <i>Perum</i> (type of SOEs), respectively (Article 71 (1)).
Local Government-Owned Enterprise Law 5/1962.	This law states that Local Government-Owned Enterprises is required to submit profit-loss statement, balance sheet and notes on financial statement to shareholder 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, then it is supported by Home Affair Ministry Decree 3/1998 concerning this entity form to be annually audited by public accountants to determine audited net income as source of public revenue.
Company Law 40/2007	Among other rules, <i>this law</i> is the most significant law concerning limited liability companies. Law replace the law 1/1995 considered no longer in accordance with the legal development and needs of society. This law stipulates the financial reporting in Indonesia. Board of Management must submit annual financial report within 6 months of the end of each fiscal year to GMS. Board of Directors and Board of Commissioners must review and sign the report before submission to GMS. This law requires financial statement prepared in accordance with Indonesian Accounting Standards. This law also required that Board of Management to financial statement to be audited by public accountant, specially to those are: using public funds (such as banking, insurance, pension plan, finance companies); issuing debt instruments; listing companies; State-owned enterprises in 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. This law required that annual report must be announced at a news paper before seven days after being approved by GMS.
'Bank Indonesia' Law 6/2009	This law is establishment of Government Regulation in Lieu of Law 2/2008 concerning 2 nd amendment of Law 23/1999 states that Bank Indonesia may assign public accountant, for and on behalf Central Bank Indonesia, to conduct financial audit or special audit.

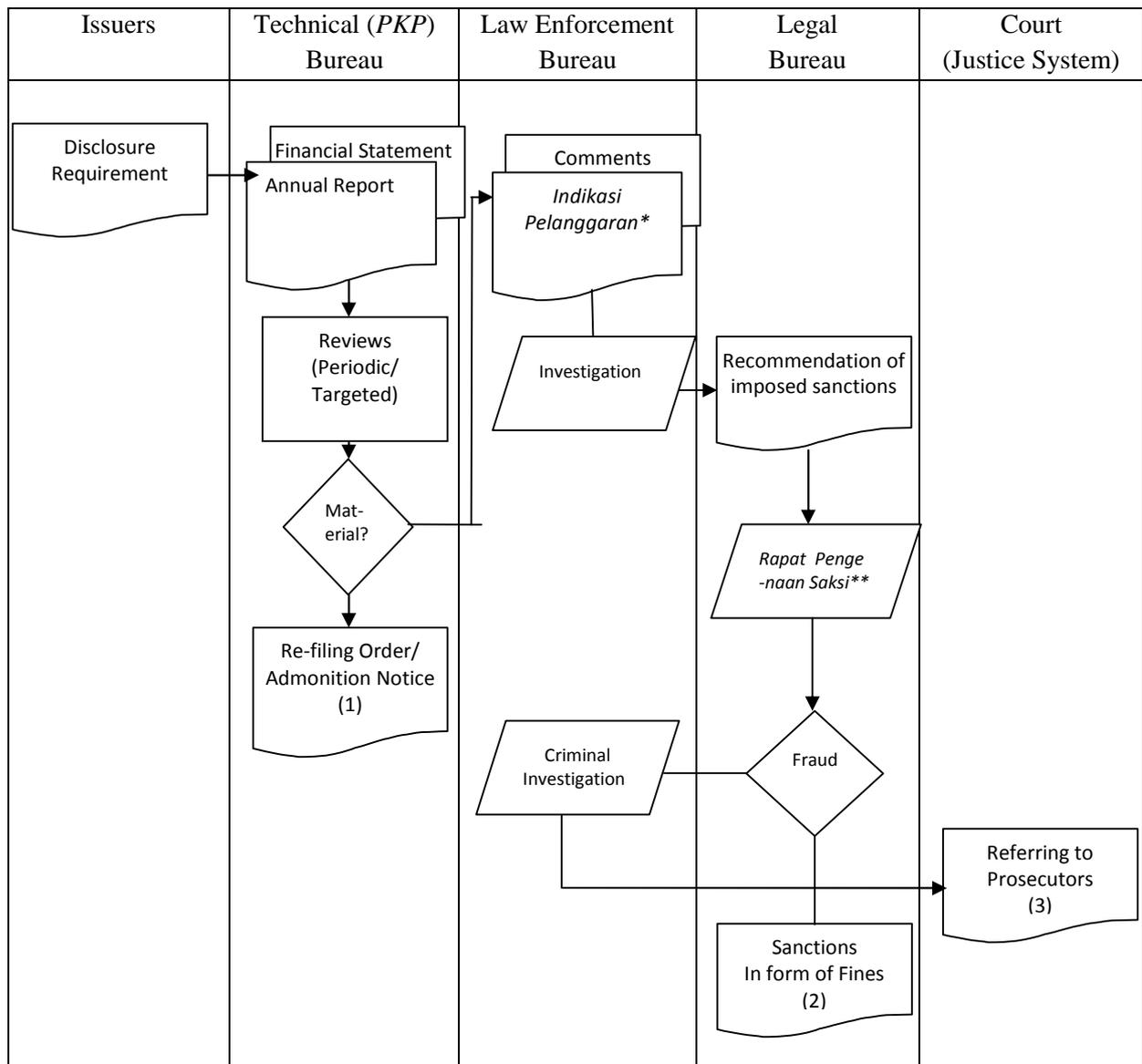
Sources: Asian Development Bank (2003); Achmad (2007); and other sources.

BAPEPAM's role on listed firms' financial reporting

BAPEPAM is the main capital market regulator in Indonesia. BAPEPAM's functions are similar to those of the US Securities and Exchange Commission (SEC). BAPEPAM may issue a formal investigation toward a person, a company or an institution that allegedly commits a violation against capital market law and

other rules. During the formal investigation, a person or a company may be asked to do and not to do a certain task, such as re-filing a financial statement, by an investigator. When there is proof of acts that harm capital markets, investors and public, then BAPEPAM may conduct a criminal investigation. BAPEPAM's civil investigators might take a case of criminal offence to a court prosecution

Figure 2: BAPEPAM Enforcement System of Reporting Issuers in Defaults



Source: Developed from BAPEPAM's annual reports 2000-2009 and other sources.

As suggested by Smaili and Labelle (2009), in order to track cases' seriousness, this paper considers three level of sanctions imposed according to their gravity of the accounting irregularities detected by BAPEPAM. Level (1) is regard the least serious case and (3) indicates the most severely case against the Indonesian disclosure requirements. **Indikasi Pelanggaran*: Indication of offence; ***Rapat Pengenaan Sanksi*: Meeting for sanctions imposition.

BAPEPAM has an authority to impose administrative sanctions against cases related to public company disclosure. BAPEPAM is facilitated by the law to deter these misstatement practices by imposing an appropriate administrative sanction (Figure 2). The administrative sanction may be imposed in the form of

finer and non-fines. As shown in Figure 2, a most serious offence may be carried on to a court prosecutor. In accounting irregularities cases, for instance, issuers who are prosecuted are categorized as the most severe case, whereas, fined and warned can be the second and the third most serious acts against disclosure

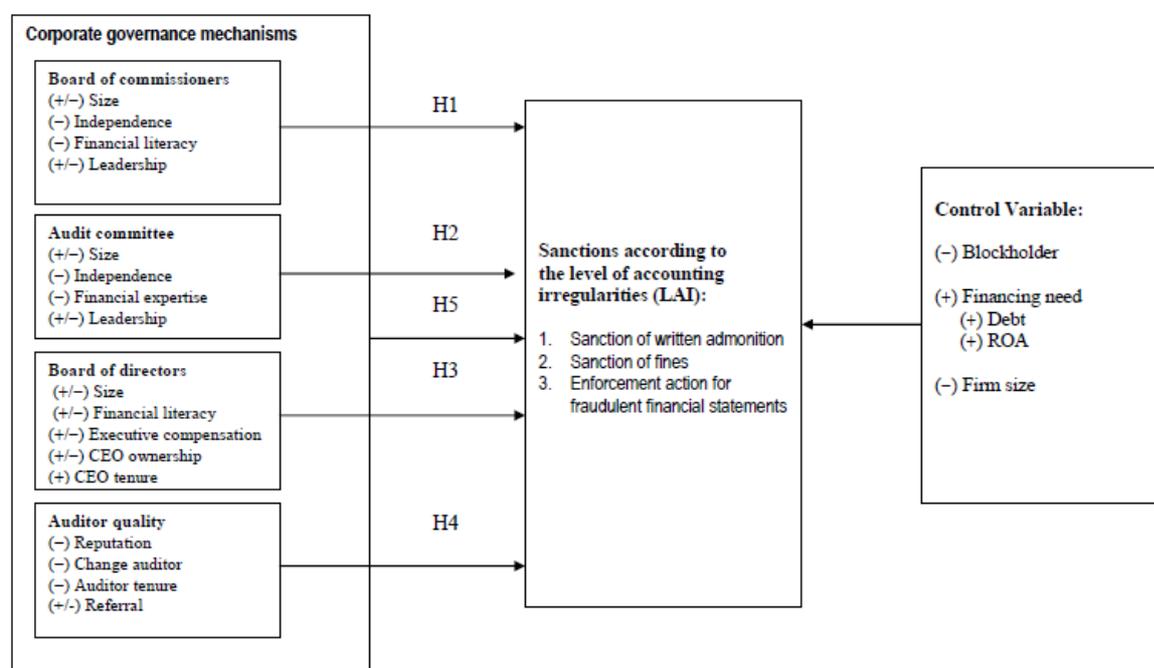
requirements. Investors and public may access the level of cases severity simply by looking at the status of BAPEPAM's sanction.

Research Hypotheses

The study's contribution to existing literature is to fill a knowledge gap by providing a detailed analysis of the

relationship between corporate governance systems and accounting irregularities in the Indonesian two-tier board structure. The methods are prepared by adapting the conceptual framework used by Smaili and Labelle (2009) into an Indonesian corporate governance context with two-tier board structure (see Figure 3).

Figure 3: Conceptual framework of the link between corporate governance mechanisms and the level of accounting irregularities



Effectiveness of Board of Commissioners

In Indonesia a Limited Liability Company is required to have a two-tier board, consisting of a BOC and BOD. Under the Company Law 2007, the role of the BOC is to supervise the policies and general operations of company management and advise the company's executives. As a general understanding, the BOC has similar monitoring responsibilities to those of the Anglo-Saxon BOD. The BOC is restricted from participating in making any operational decisions (Lukviarman, 2004;

Robinson, 2009; Tabalujan, 2002; Wibowo, 2008), whereas the BOD is composed of executives who direct all business operations.

An effective BOC plays a crucial role in the corporate governance mechanism to achieve company goals. However, just a few studies have been undertaken concerning the dimensions of an effective BOC (supervisory board). Considering that the function of a BOC is similar to a BOD 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 tendency of accounting fraud. Beasley (1996), Beasley et al. (2000a) and Abbott et al. (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 and long director tenure. Jensen (1993) suggests that when board oversized they are less likely to function effectively because the coordination and process problems overwhelm the advantages gained from having more personnel to draw on.

By comparing to the dimensions of the BOD in a one-tier structure and adapting to Indonesian legal requirements, this study will develop a Board of Commissioners' score to rate the likelihood of accounting irregularities. This score is used to empirically test the following hypothesis:

H1: The effectiveness of Board of Commissioners is negatively associated with the gravity of incidence of accounting irregularities.

Effectiveness of Audit Committees

In addition, the system uses board committees to assist the BOC. The NCCG (2006) requires audit committees to assist the BOC in ensuring that a company complies with reporting matters. The audit committee is chaired by an independent commissioner and members consisting of other commissioners and or external professionals. 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, et al., 2004; Agrawal & Chadha, 2005; Baxter, 2007; Farber, 2005). Therefore, this study uses a score for the effectiveness

of audit committee to test the following hypothesis:

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

Board of directors (Board of Management)

In the German two-tier board system, Du Plessis et al. (2005) states that the Board of Management is 'elected and dismissed' by the BOCs. This situation is argued to give shareholders an opportunity to nominate representatives to protect their interests against executive directors. Therefore, the existence of an 'election and dismissal right' of BOCs is argued to be the cornerstone of BOCs' monitoring effectiveness over Board of Managements.

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

As Indonesia uses a two-tier board system, BOCs have similar dimensions to those of the one-tier Anglo-Saxon BODs. However, there is inconclusive evidence of the effectiveness of Boards of Management in the two-tier system legal environment. Therefore, as Indonesian BODs have similar functions to the CEO and Executive Directors in Anglo-Saxon countries, the effectiveness of Indonesian BODs may be measured by applying a

survey of Executive Directors from the Anglo-Saxon one-tier board system.

There are some circumstances under which Indonesian BODs may be able to effectively exercise their duties. Among other things, the Indonesian Code provision (NCG, 2006) mentions that: (1) composition of the BOD shall be of sufficient size to suit the complexity of the business; (2) members of the BOD must be professional in terms of capability and integrity; and (3) the role of the BOD shall cover the main tasks in areas of management, including internal control. Moreover, some scholars argue that executive compensation (Barkema & Gomez-Mejia, 1998) and CEO tenure (Dunn, 2004; Smaili & Labelle, 2009) determine the degree of governance implementation. This study will incorporate the NCCG guidelines and previous research to measure BOD's effectiveness by developing a BOD score to rate the likelihood of accounting irregularities. Therefore, this study develops a score for BOD's effectiveness to empirically test the hypothesis, in an alternative form:

H3: There is an association between Indonesian Board of Directors' dimensions and the gravity of incidence of accounting irregularities.

Audit quality

Audit quality is an important attribute in ensuring that market participants have confidence in published financial statements. Furthermore, auditor reputation and independence, existing referral of parent company auditor, change of auditor and auditor tenure are important for maintaining audit quality (Farber, 2005; Johnson, Khurana, & Reynolds, 2002; Myers, Myers, & Omer, 2003; Piot & Janin, 2005). In addition, as the reputation of the non-Big 4 auditors does not always represent less auditor effectiveness, other

attributes of auditors 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 an occurrence of restatement is frequently preceded by a change of external auditor. However, a situation where changing the 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 according to Carcello and Nagy (2004). They argue that longer tenure can improve auditor expertise due to superior client-specific knowledge. Therefore, this study will summarize auditor dimensions with an auditor score to test the following hypothesis:

H4: The audit quality is negatively associated with the gravity of incidence of accounting irregularities.

Interdependency among Governance Mechanisms

As suggested by Smaili and Labelle (2009), rather than only investigating individual corporate governance mechanisms such as 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 together. Therefore, this study will utilize scores indicated in previous sections to explore the interaction effect on the likelihood of misreporting practices. Here it is hypothesized that interaction between prominent characteristics of corporate governance mechanisms may prevent the 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.

Apart from the aspects of corporate governance above, factors including financial need, presence of block holders and a firm's size are included in the model for this study. This is because financially distressed firms will have the same likelihood of fraudulent financial reporting (Carcello & Nagy, 2004; Wardhani, 2006) as those that are not financially distressed. Non-affiliated block holders on boards and company sizes are other factors influencing ethical behaviour in financial reporting (Chen, et al., 2006; Siregar & Utama, 2008).

Sample And Research Methods

This section presents the company sample selection, defines the experimental variables and develops the empirical analysis methods to provide tools for answering the hypotheses.

Sample selection and description

The sample consists of 78 listed companies according to BAPEPAM's annual report from 2000 to 2009. Since 2000, listed companies have been considered

implementing the first ever country code. In addition, the 10 years period is intended to capture sufficient number of firms that commit to accounting irregularities. Cases related to accounting irregularities are gathered from BAPEPAM's annual report. This study uses BAPEPAM tracking of law enforcement (Figure 2), to identify the gravity of accounting irregularities. Additionally, corporate governance dimensions are sourced from firm's annual reports.

The gravity of accounting irregularities is based on the type of sanctions imposed by BAPEPAM. Firms with accounting irregularities are categorised into three groups: admonished firms, fined firms, and investigated (prosecuted) firms. BAPEPAM indicates the enforcement action undertaken to issuers who allegedly committed a reporting wrong-doing on its annual reports. BAPEPAM is responsible for law enforcement to protect investors under Law No.8/1995 in the IDX. According to this Act, BAPEPAM is authorised to impose sanctions according to the level of seriousness (see Figure 2). Finally, companies with no accounting irregularities will be included as control samples.

Table 2: Summary of Main Sample Selection

Cases Handled by BAPEPAM	The 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's annual report 2000 – 2009.

Table 2 provides a summary of a sample selection consisting of 78 issuers indicated

on BAPEPAM's annual report from 2000 to 2009. As this study focuses on the

incidence of misstatements, the samples are determined by cases related to issuers' disclosures. The table provides the total cases handled by BAPEPAM and also the number of cases indicated in its annual report. Those indicated are the only valid sample, instead of total number of cases that are confidentially kept by the BAPEPAM office.

The 78 issuers with disclosures in default, half of the 156 total samples, are

distributed across a wide variety of Indonesian industry as shown in Table 3. The largest group of companies (34 or 43.58%) are concentrated in the finance sector and the trade, services and investment industry. They are followed by 20 companies (40%) in the manufacturing industry. The consumer goods industry was the third largest with 11 firms (14.10%).

Table 3: 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's annual report 2000 – 2009.

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). If within a two-digit industry a matching sample is not available, a one-digit JASICA code is considered. The firm who committed accounting irregularities and matched firms are of similar size ($t=0.462$; p -value 0.645) suggesting that the matching method is successful. The average size of fraudulent firms (LOGSIZE) is 27.310 (median 27.560) 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 millions (median IDR932, 500 millions) and IDR3, 250,668 millions (median IDR1, 122,500 millions) for non-fraudulent issuers.

Empirical analysis methods

This study uses univariate and multivariate analysis to test the relationship between corporate governance mechanisms and the sanctions level applied to accounting irregularities (LAI). In line with previous literature (Chen, et al. 2006; Smaili & Labelle 2009), ordinal regressions are used to test the research questions since the dependent variable, LAI, is an ordered categorical variable which takes values of 0 for matching samples, 1 for admonished firms, 2 for fined firms and 3 for firms referred to prosecutors.

As a first step, this paper 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 based on the Code and regulations in order to explore preliminary

analysis of hypotheses. Multivariate analysis (individual models and integrated models) will carefully analyse the relationship of corporate governance dimensions and the level of accounting irregularities (LAI).

The individual models (IMs) are used to investigate whether individual governance mechanisms are negatively associated to the LAI. The IMs are used to test the relations between BOC (IM1), audit committee (IM2), BOD (IM3), and auditor (IM4) characteristics and the LAI. In the IM1, this study investigates the proportion of independent BOC (*unrelated*), BOCs' ownership (*ownerBOC*), the presence of block holder (*blockingBOC*) and number of commissionerships in other firms (*NSeat*), financial experts on BOC

(*BOCexpert*), financial literates on BOC (*BOCComp*) and BOCs' leadership (*BOCLeader*). Moreover, the IM2 tests the relation between audit committee dimensions and the LAI. This investigates audit committee size (*size*), proportion of independent members (*unrelatedaudit*), committees' leadership (*auditleader*), presence of financial expert (*auditexpert*) and financial literacy (*auditcomp*) on the committees. Four control variables are also included. First, 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. Lastly, a total asset (size) is used to control the effect of firm size. Appendix 1 describes the variables' definition.

$$LAI = \alpha_0 + \alpha_1unrelated_i + \alpha_2ownerBOC_i + \alpha_3blockingBOC_i + \alpha_4NSeat_i + \alpha_5BOCexpert_i + \alpha_6BOCComp_i + \alpha_7BOCLeader_i + \alpha_8ownerblock_i + \alpha_9debt_i + \alpha_{10}ROA_i + \alpha_{11}size_i + \varepsilon_i \dots \dots \dots IM1$$

$$LAI = \alpha_0 + \alpha_1unrelatedaudit_i + \alpha_2auditleader_i + \alpha_3auditexpert_i + \alpha_4auditcomp_i + \alpha_5ownerblock_i + \alpha_6debt_i + \alpha_7ROA_i + \alpha_8size_i + \varepsilon_i \dots \dots \dots IM2$$

The IM3 model examines the Indonesian BODs or the Board of Management (known as the *direksi*) aspects related to the LAI. According to NCCG guidelines (2006) and literature, the attributes of an effective BODs are the number of executive directors (*size*), competence

(number of directors with financial literacy [*BODcomp*]), integrity (*CEOtenure* and *BODownership*) and an internal control over financial reporting (*ICFR*). Executive compensation is also an important determinant. The control variable remains the same.

$$LAI = \alpha_0 + \alpha_1size_i + \alpha_2BODComp_i + \alpha_3CEOtenure_i + \alpha_4BODownership_i + \alpha_5ICFR_i + \alpha_6compensation_i + \alpha_7ownerblock_i + \alpha_8debt_i + \alpha_9ROA_i + \alpha_{10}size_i + \varepsilon_i \dots \dots \dots IM3$$

The last individual model (IM4) tests the relation between auditor quality and the LAI. This examines auditor quality

including auditor reputation, change of auditor, and auditor tenure. Control variables are included

$$LAI = \alpha_0 + \alpha_1big4_i + \alpha_2auditchange_i + \alpha_3audittenure_i + \alpha_4ownerblock_i + \alpha_5debt_i + \alpha_6ROA_i + \alpha_7size_i + \varepsilon_i \dots \dots \dots IM4$$

Apart from IMs examining the impact of the individual governance mechanism on the LAI, the integrated or combinative models (CMs) are used to examine whether governance mechanisms work simultaneously as a system. CM1

examines whether BOCs, audit committees, BODs and auditor quality affect to the LAI. CM2 introduces an interaction term of the presence of independence commissioners in audit committees (*unrelatedaudit*) and assigns

Big 4 auditor (*big4*). CM2 confirms collaboration between audit committees and external auditors as prominent mechanisms in reducing the LAI. Moreover, CM3 proposes an interaction

$$LAI = \alpha_0 + \alpha_1 BOC_score_i + \alpha_2 audit_score_i + \alpha_3 BOD_score_i + \alpha_4 auditor_score_i + \alpha_5 ownerblock_i + \alpha_6 debt_i + \alpha_7 ROA_i + \alpha_8 size_i + \varepsilon_i \dots \dots \dots CM1$$

$$LAI = \alpha_0 + \alpha_1 BOC_score_i + \alpha_2 audit_score_i + \alpha_3 BOD_score_i + \alpha_4 auditor_score_i + \alpha_5 unrelatedaudit*big4_i + \alpha_6 ownerblock_i + \alpha_7 debt_i + \alpha_8 \Delta ROA_i + \alpha_9 size_i + \varepsilon_i \dots \dots \dots CM2$$

$$LAI = \alpha_0 + \alpha_1 BOC_score_i + \alpha_2 audit_score_i + \alpha_3 BOD_score_i + \alpha_4 auditor_score_i + \alpha_5 (BOC_score*audit_score)_i + \alpha_6 ownerblock_i + \alpha_7 debt_i + \alpha_8 ROA_i + \alpha_9 size_i + \varepsilon_i \dots \dots \dots CM3$$

Appendix 1 provides the operationalization and summary of research variables.

Empirical Evidence And Discussions

This section describes the characteristics of firms committing accounting irregularities, and compared with those not doing so, using a means different analysis to compare the two groups. This statistical analysis is used to determine the effectiveness of individual governance dimensions and governance as a system.

Descriptive statistics and univariate analysis

Descriptive statistics and univariate analysis of variables for the effectiveness of BOCs, audit committees, BODs and audit quality for fraudulent firms and compliant companies are provided to reveal how corporate governance mechanisms work in a two-tier board system. Here the statistic descriptive statistics for LAI and the group mean difference is important in understanding how the two-tier system works.

Statistics reported in Table 2 indicate that firms with accounting irregularities. It comprises none of issuers with LAI = 1; 62 issuers with LAI = 2 and 16 issuers with LAI = 3. The sample frame is also showing that the most used sanction imposed as administrative fine (see Table 2 and Table 3).

between BOCs and audit committees in ensuring a vigilant supervision to avoid misstatement reporting. The previous 4 (four) control variables are still included.

Board of commissioners characteristics of Table 5 below presents the findings related to H1 (see Figure 3) showing that the BOC membership of compliant firms is statistically less than their sanctioned counterparts (t test = -1.522; $\alpha = 5\%$). In addition, the average proportion of unrelated members of compliance firms is 39%, whereas sanctioned firms were 37%. The BOC ownership is higher in sanctioned firms, whereas the existence of block holders is higher in compliant firms. However, the number of seats showing the commissioners' good reputation does not show any statistical difference. Moreover, the BOCs' financial expertise among firms that commit to AI are significantly smaller (t test = 2.279; $\alpha = 5\%$) than those that comply with disclosure rules. This means that financial expert members are more likely to supervise their management team in order to avoid AI. The panel data in Table 5 shows that listed firms appoint more financially literate members on their BOCs, than qualified experts. Firm's chairman headed by both independent and affiliate members showed no statistical difference.

Audit committee characteristic of Table 5 shows that, on average, audit committees consist of three members. In relation to H2 regarding audit committee effectiveness

(Figure 3), both BAPEPAM and IDX require listed companies to appoint audit committees that are at least comprised of an independent commissioner (as chairman) and two outside members, one of whom has an accounting or finance degree. In this study the proportion of unrelated members of both sample groups is statistically the same. In addition, firms that commit to AI have only 17% of audit committee members that are considered expert, whereas the control firms have 37% of expert members. Financially literate members of audit committees in both cases are the same. This preliminary finding indicates that appointing expert members can be more effective in deterring AI, due to the pressure of maintaining their reputations as diligent in assisting the BOCs. Study by Smaili and Labelle (2009) confirms the results.

Findings reported in board of management features of Table 5 indicate that CEO tenure and management attention towards internal control are both dimensions that lower accounting irregularities. The benefit of having a long tenured-CEO is consistent with upper echelons perspective proposed by Hambrick and Mason (1984). These dimensions are statistically different at 5%. Additionally, the presence of financially literate directors on executive boards shows no statistical difference. Executive directors' ownership is also statistically indifferent as far as this dimension is used to align management and shareholders' interest (Agrawal & Chadha, 2005; Eisenhardt, 1989). The dimension of BOD compensation shows no difference; and according to the agency theory, this could be an anomaly. The study by Wilopo in Indonesia (2006) also confirms the anomaly result.

Table 5: Mean Comparisons of 78 Non-Accounting Irregularities Firms Matched with 78 Firms Indicted at Various Accounting Irregularities

Variables	Committed AI			Mean of Non-AI	t-test	p-value
	Min	Max	Mean			
<i>Board of Commissioners</i>						
BOCSize	2	12	4.370	3.920	-1.522	0.015*
Unrelated	0	1.000	0.391	0.367	-1.058	0.292
OwnerBoC	0	0.976	0.037	0.017	-1.068	0.287
BlockingBoC	0	12	1.760	1.884	0.459	0.647
NSeats	0	24	4.310	3.833	-0.684	0.495
BOCexpert	0	1	0.170	0.358	2.279	0.024*
BOCComp	0	5	1.030	1.076	0.380	0.705
BOCLeader	0	1	0.015	0.076	-1.505	0.134
BOC score	1	[0 = 66; 1 = 12]	2.000	2.260	[0 = 72; 1 = 6]	0.006*
<i>Audit Committee</i>						
AuditSize	0	7	2.420	2.740	1.638	0.100**
Unrelatedaudit	0.000	0.670	0.273	0.294	0.892	0.292
Auditleader	0	1	0.270	0.410	1.868	0.287
		[0 = 57; 1 = 21]			[0 = 46; 1 = 32]	
Auditexpert	0	2	0.170	0.371	2.612	0.010*
Auditcomp	0	2	0.870	0.974	1.075	0.284
Audit score	1	3	1.58	1.94	2.543	0.012*
<i>Board of Management</i>						
BODSize	2	10	4.400	4.483	-0.462	0.645
BODcomp	0	1	0.230	1.327	1.660	0.099**
CEOTenure	0	27	5.330	7.258	2.194	0.030*
BODownership	0.000	0.666	0.018	0.014	-0.715	0.475
ICFR	0	1	0.280	0.914	8.899	0.000*
		[0 = 55; 1 = 22]			[0 = 11; 1 = 67]	
Compensation	0.000	0.260	0.024	0.025	0.223	0.824

BOD score	1	3	1.600	2.380	7.087	0.000*
Auditor Quality						
Big 4	0	1	0.400	0.500	1.286	0.200
		[0 = 47; 1 = 31]			[0 = 39; 1 = 39]	
Referral	0	1	0.080	0.230	2.708	0.008*
		[0 = 72; 1 = 6]			[0 = 60; 1 = 18]	
Auditchange	0	1	0.410	0.280	-1.687	0.094**
		[0 = 46; 1 = 32]			[0 = 56; 1 = 22]	
Audittenure	1	5	1.870	2.010	0.931	0.353
Opinion	0	1	0.490	0.770	3.786	0.000*
		[0 = 40; 1 = 38]			[0 = 18; 1 = 60]	
Auditor score	1	3	2.030	2.220	1.614	0.109
Control Variables						
Ownerblock	0.057	0.976	0.653	0.685	1.141	0.255
Debt to equity ratio	-31.819	27.225	1.323	3.526	1.392	0.166
Return on assets	-0.960	0.451	-0.029	0.009	1.444	0.151
Log Size	22.669	31.610	27.309	27.254	-0.121	0.904
Size Change	-0.541	20.982	0.549	0.112	1.621	0.107

* and ** statistically significant at 5% and 10%, respectively. Mean of dummy variables (see appendix 1) are meaningless, they do only represent tendency. Frequency of dummy variables is presented to provide detail information.

Audit quality characteristics of Table 5 shows that 40% of the firms to commit AI are audited by a big 4 auditor as compared to 50% in the case of control companies, however, the difference is not statistically significant. It is interesting to note that a large proportion of firms that commit AI have changed their auditor in the period before BAPEPAM detection. Moreover, the analysis shows that a situation where a changing auditor is caused by referral (t-test=2.708; $\alpha=5\%$) constitutes a lower LAI (Branson & Breesch, 2004). In addition, the control firms seem to have longer auditor tenure than those that commit to AI, but not significantly. Finally, the firms subjected to authority investigation receive less 'unqualified opinion' on their financial statements (t-test=3.786; $\alpha=5\%$).

As in Carcello and Neal (2003), this study also noticed that a majority of the firms committing AI have negative performance. However, both sample groups show no statistical difference on their block holders, financial need (leverage and ROA) and total assets. In broad-spectrum, the above mean differences analyses are in line with the hypotheses mentioned in this conceptual framework.

Multivariate results

Table 6 provides ordinal regression results for both the IMs (equation 1 to 4) and the CMs (equation 5 to 7). Each of the IMs assumes the relationship of an individual corporate governance mechanism with the LAI. Hence, the findings might provide an empirical solution in minimising the problem of disclosure non-compliance. In addition, the CMs will broaden the view with regard to the benefit of governance as a system and the synergy among key monitoring tools.

Effectiveness of individual corporate governance dimensions

Regarding H1 (Figure 2), the individual equation presented in the IM1 column of table 6 shows that the presence of a BOC member with financial or accounting expertise (*BOCexpert*) is more likely to avoid AI and reduce their seriousness ($\alpha=-0.564$, $p<0.10$). The existence of block holders (ownership>5% of shares) and the presence of other commissioners who are financially competence (but not an expert) are among dimensions that could limit the seriousness of AI. However, these are statistically insignificant. This finding could be seen as an explanation of insignificant

effect of independent BOCs (*unrelated*) on management misreporting behaviour.

When the appointment of an independent commissioner is used to 'tick the box' only, indeed their presence on BOC will not influence the better level of BOC monitoring roles. This is consistent with Djonieri's argument (2010) that those BOC members in Indonesia are usually influenced by the controlling owners. Even the BOCs' membership comprises non-executive directors only, but the majority of those are related parties. The current IDX listing rule requires at least 30 percent of total BOC to be independent commissioners. Therefore, a 30% of membership is not enough resources to influence the majority of affiliated members in preventing a misreporting behaviour. Shares held by the commissioners (*OwnerBOC*), commissioners' reputation (*NSeat*) and BOCs' leadership shows no statistical significance. Therefore, it could be concluded that a presence of financial or accounting expertise on BOCs is an important factor in minimising the

seriousness of AI and deterring the future incidences.

In the next column, IM2 regarding H2 shows that the presence of financial and accounting experts on the audit committees is negatively associated with the LAI ($\alpha=-1.183$, $p<5\%$). This is consistent with other previous studies (Bedard, Chtourou & Courteau 2004; Farber 2005; Smaili & Labelle 2009). Next, the appointment of commissioners who are financially literate (*auditleader*) and the presence of other members with general finance and accounting understanding (*auditcomp*) are also negatively associated with the misreporting incidences, but the relationships are statistically insignificant. The finding is consistent with study by a Smaili and Labelle (2009) which suggests policy to be tightened. In Indonesia, BAPEPAM 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'. The study result recommends considering 'the experience aspects' in addition to 'the education background' requirement.

Table 6: Relationship between Corporate Governance Dimensions and the Level of Accounting Irregularities

	Predicted Sign	Individual Models (IMs)			
		IM1	IM2	IM3	IM4
Constant of LAI = 1		1.308	4.054	7.569	4.282
Constant of LAI = 2		3.252	6.452	10.734	6.770
Unrelated	-	.425			
OwnerBOC	?	1.182			
BlockingBOC	-	-.027			
NSeat	+	.040			
BOCexpert	-	-.564**			
BOCcomp	-	-.097			
BOCleader	?	.541			
Unrelatedaudit	-		1.338		
Auditleader	-		-.020		
Auditexpert	-		-1.183*		
Auditcomp	-		-.612		
BODSize	-			-.121	
BODcomp	-			.415	
CEOtenure	-			-.058**	
BODownership	-			7.891*	
ICFR	-			-3.218*	
Compensation	-			-4.362	
Big 4	-				-0.377
Referral	-				-1.062*
Auditchange	+				0.590
Audit tenure	-				0.016

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

Concerning H3, IM3 shows the dimension of the BOD. Among other things, CEO tenure and internal control are statistically significant at 10% and 5%, respectively. Longer tenured-CEOs are less likely to engage in risky behaviour by sacrificing his/her reputation. This is consistent with previous studies, especially Echelon Theory (Dunn, 2004; Gray & Cannella Jr, 1997; Hambrick & Mason, 1984). Then, a positive attitude toward the role of internal control within financial reporting seems to limit the seriousness of AI. This study supports the SOX Act of 2002 concerning an assessment of internal control over financial reporting (ICFR). In addition, shareholding by executive officers (BOD members) positively influence the level of AI ($\alpha=7.981$, $p<5\%$). As the average of their ownership is as little as 1.8% of total shares, the executive officers may only be concerned with current earnings. Therefore, this situation makes for higher probability that a financial statement could be stated unfairly. The compensation and number of BOD memberships are not statistically significant.

The IM4 concerning H4 indicates that a situation where the listed companies appoint the same auditor as the holding firm (*referral*) is negatively associated with the level of AI ($\alpha=-1.062$, $p<5\%$). 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 4 auditors are negatively associated with the level of misreporting behaviour, but it is

not significant. Auditor switching and audit tenure are not statistically significant. Change of auditor is not going to lead a high level of an erroneous financial reporting, since this only complies with auditor rotation rules.

In general, the detail results from IM1 to IM4 confirm that accounting irregularities are more serious when: (a) there is absence of a financial expert on the BOC and on the audit committee; (b) a management has a shorter tenured CEO, considerable shares held by officers and weak internal control; and (c) an auditor is appointed by an internal parties without a referral from block holders or parent company.

Effectiveness of corporate governance as a system

Table 7 provides multivariate analysis in relation to the H5 (Figure 2). Three integrated or combinative models (CM1, CM2, and CM3) are used to specify whether Indonesian corporate governance negatively affects the LAI. The CM1 determines the simultaneous effect of the BOCs and audit committee, the board of directors, and the audit quality on the LAI. In general, as result of CM1, all aspects of corporate governance dimension are negatively associated with the LAI. However, 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 CM1 result also suggests that the overall monitoring role of BOC and audit committee over listed companies' financial reporting was questionable.

Table 7: The Relationship of Corporate Governance as a System and The Level of Accounting Irregularities

	Predicted Sign	CM1	CM2	CM3
Constant of LAI = 1		2.845	1.055	-1.734
Constant of LAI = 2		5.653	3.788	1.069
BOC_score	-	-0.261	-.428	-1.624*
Audit_score	-	-0.156	-.229	-1.750*
Auditor_score	-	-0.423**	-1.118*	-1.083*
BOD_score	-	-1.262*	-.325	-0.399
Unrelatedaudit * Big4	-		-.124	
BOC_score * Audit_score	-			-.671**

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

In addition to the role of each CG dimension, this study also examines the interdependence among the dimensions. The CM2 model determined the presumed synergy between the presence of independent commissioners on audit committees (*unrelatedaudit*) and audit engagement with big 4 auditors (*Big4*) on the LAI. However, the interaction effect of this relationship is not significant. The CM3 model shows that the coefficient of interaction term of *BOC_score*Audit_score* is negative and significant. This provides evidence that a diligent monitoring between BOC and audit committee can reduce the seriousness of misreporting behaviour. The explanatory power (pseudo R-square) of CM3 is the highest among the proposed models. This means that the interdependence among corporate governance mechanism could be deter and reduce the level of accounting irregularities.

Summary And Recommendations

This study investigates the extent to which Indonesia's corporate governance mechanism acts as an effective tool for protecting the investing public against various levels of financial misstatements. The investigation is conducted by examining not only the occurrence of such erroneous financial reporting but also their seriousness. Using the database of BAPEPAM law enforcement action, this

study determines the detail of a serious disclosure offence during the period 2000-2009.

Using univariate analysis, this study finds mean difference among corporate governance dimensions. A listed company with small size BOC and employing financial expert(s) on BOC and their audit committee is less likely to misstate financial information. In addition, there is also the role of top management in preventing accounting irregularities. The study reveals the importance of a sound internal control system and financially competent officer(s) on the board of management. Regarding external corporate governance mechanisms, the source of auditors do not seem to influence audit quality. According to the mean difference analysis, an unqualified opinion and the existence of a 'referral' auditor are significantly higher for listed companies that comply with disclosure requirements.

Further analysis reveals that accounting irregularities are negatively associated with the quality of corporate governance in a two-tier board system. The main contribution of this research resides in ordinal regression which examines the relationship between corporate governance and the seriousness of accounting irregularities occurrences. The level of misstatement in financial information is more severe when: (a) there is absence of financial expert(s) both on supervisory

boards and their audit committee; (b) there is a short tenured-CEO with poor internal control systems, and (c) an auditor is solely appointed by the firm's BOC without agreement of the block holders or holding company (known as referral). In addition, an examination of the simultaneous effect of each corporate governance dimension reveals a general weakness of the BOCs and their audit committee. However, the BOC and audit committee could be an effective tool in mitigating the incidence of financial misstatements, when they show a high quality of collaboration.

This study extends previous studies regarding an approach in predicting listed companies that likely publish misleading financial reporting, particularly in a two-tier board structure environment. By taking into consideration the nature of accounting irregularities, it not only investigates the causes of such incidences but also their degree of non-compliance. Therefore, this

research design allows scholars to focus on the corporate governance dimensions that likely cause the most serious non-compliance with financial reporting requirements. The using of the Indonesian two-tier board systems with regard to its specific governance practices contributes to understanding the role of supervisory boards, audit committees, board of directors (board of management) and auditors. Measurement of board of management' effectiveness that is completely separated from the supervisory board is also included. This study provides insight by using the regulatory enforcement action data as a genuine source to detect the weakness of current governance systems. Therefore, significant results could be synthesized to the above specific corporate governance mechanisms that effectively deter a serious breach of disclosure laws and regulations.

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Appendix 1: Operationalization and Summary of Dependent and Independent Variables

Variables	Description	Expected Sign
Dependent Variable		
Level of Accounting Irregularities (LAI)	Measured by the level of sanction imposed according to BAPEPAM. Equal 1 for admonition letter sanctioned, 2 for fined, and 3 for law enforcement after the discovery of accounting irregularities. Equal 0 for each matching samples.	
Independent Variables		
<i>Board of Commissioners (BOC)</i>		
BOCSize	Size of Board of Commissioners	?
Unrelated	Percentage of unrelated Commissioners	-
OwnerBOC	Percentage of share held by Commissioners	?
BlockingBOC	Number of non-affiliated block holder's BOC	-
NSeat	Number of commissionership in other firms	+
BOCexpert	Number of financial/accounting (F/A) expert on BOC	-
BOCComp	Number of member with some knowledge with 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 is present on the 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 committees	-
Auditcomp	Number of committee member with some knowledge of F/A	-
Auditleader	Dummy variable, equal to 1 if audit committee is led by F/A expert or financial 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>		
<i>Board of Management</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 is not established; and 2, in all other cases (developed from NCCG 2006)	?
<i>Auditor Quality</i>		
Big 4	Equal 1 if auditor is Big 4 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 auditing	?
Opinion	Equal 1 if financial statement with unqualified opinion, 0 in all other cases.	?
Auditor_score	3, if the auditor is part of Big 4 and no change of auditor, 1 if	-

the auditor is not Big 4 affiliated and change prior the incidence, and 2, in other cases (developed from Smaili & Labelle 2009).

Control Variables

Ownership		
OwnerBlock	Percentage of share 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)