

Good Corporate Governance on Integrity of Financial Statements

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Abstract—This study aimed to obtain empirical evidence from the influence of Good Corporate Governance on the integrity of financial statements. Good Corporate Governance using proxies of managerial ownership, institutional ownership, independent commissioners and audit committee. This study analyzed the secondary data of companies in the manufacturing sector listed on the Indonesia Stock Exchange (IDX). The samples were collecting 20 companies in the period of 2012 to 2016 through the so-called purposive sampling technique. The analysis methodology performed multiple regression test. Based on the research result, it can be concluded that managerial ownership have positive effects on the integrity of financial statements. It means that the high percentage of the managerial ownership can improve the integrity of financial statements. On the other hand, the audit committee negatively affects the integrity of financial statements. Meanwhile, institutional ownership and independent commissioners have no influence on the integrity of financial statements.

Keywords: *managerial ownership, institutional ownership, independent commissioner, audit committee, the integrity of financial statements*

I. INTRODUCTION

One component used to assess company performance is its financial statements. The financial statements were produced by the management to account for the tasks assigned to them by the owners of the company. Furthermore, the financial statements serve as reports to parties outside the company. The information available in the financial statements are usually needed for investors, suppliers, employees, government, and society for consideration in decision making. Therefore, the data in the financial statements must have high integrity so as not to mislead those users. Financial reports with high integrity are more trusted by users in decision making because the financial statements present information without any

elements of fraud on it [20]. In fact, there are still many companies whose credibility are considered doubtful. This happens mainly due to a lot of manipulations towards accounting data, especially financial reports.

In Indonesia, nowadays, discussions about ‘Corporate Governance’ are still a hot issue. To assess the integrity of financial statements published, the role the board of commissioners in a public company is to respond in conducting a company’s supervision and ensuring its GCG practices in order to produce high quality and integrity of financial statements. Companies that have a highly qualified GCG structure can improve company performance and reduce possible fraud [14]. GCG practices in this study are focused mainly on the factors of managerial ownership, institutional ownership, independent commissioners, and audit committee.

A. Agency Theory

Agency theory is a theory explaining the relationship between the agent and the principal. Ref. [15] described that agency relationship is a contract whereby one person or more (principal) rules another person (agent) for a service on behalf of the principal and authorizes the agent to make the best decision for the principal.

According to [18], in each individual organization (called the agent) will act as a party that is trusted by another individual or group of individuals (called the principal), the relationship between the two (also called as the principal-agent relationship) will occur in the company organization between shareholders as principals with managers as agents.

B. Integrity of Financial Statements

According to Indonesia Chartered Accountant [13], the integrity of financial statements shows the accountability, accuracy and trustworthy of information provided and free from intentional actions or activities by the board management in manipulating of accounting data in order to mislead users in evaluating the company. Appropriate data require a transparent

presentation of transactions, events and other conditions in accordance with definitions and criteria for assessing assets, liabilities, incomes and expenses which are standardized in the framework of preparing and presenting good financial statements.

C. Good Corporate Governance

Forum for Corporate Governance in Indonesia [8] defined the term of 'corporate governance' as a set of rules that regulate a relationship between shareholders, a board of directors, government, employees and other internal as well as external stakeholders related to rights and obligations. In other words, it is a system that regulates and controls the company. Ref. [17] put the term of Corporate Governance as an effort to maintain the relationship between three important actors (i.e. owner, management, and board of direction or BOD) in each corporation. To emphasise on their relationship and interaction in the corporate governance practices, the approach used is based on the governance structure as the main element in every corporate governance system. The relationship between the three elements in the corporate governance system will determine the direction as well as the performance of the corporation according to the established mechanism.

D. Managerial Ownership

According to [19], the structure of managerial ownership can be explained through two perspectives, namely the agency approach and the sustainability approach. The first approach considers the structure of managerial ownership as an instrument or a tool used to reduce agency conflicts among several claims against the company. The later approach views the mechanism of managerial ownership structure as a way to reduce information imbalances among *insiders* through the disclosure of information within the company.

The existence of management ownership in a company will lead to an allegation that it can increase the company value. This is potentially helpful in reducing the allocation of unfavorable resources, which consequently will increase the value of the company [5]. A research conducted by [24] showed that there is a positive influence on the integrity of financial statements. In contrast to the research results of [25], managerial ownership has a negative effect on the integrity of financial statements. In addition, the research of [23], [32], [7], showed that managerial ownership did not affect the integrity of financial statements. Therefore, the formulation of the hypothesis is as follows:

H₁ : *Managerial ownership influences the integrity of financial statements*

E. Institutional Ownership

According to [16], institutional ownership is the percentage of shares owned by parties outside the company to the total shares of the company. Institutional investors are investors in the form of business entities or experienced institutions so that they can carry out the supervision functionality in a more effective way and are not easily trusted by manager actions such as data manipulations in the financial statements.

Based on the research conducted by Fajaryani [7], institutional ownership exhibited a positive effect on the integrity of financial statements. The existence of institutional investors can optimize the supervision functionality in the management performance in order to minimize the opportunistic behaviors of management that acts for their own interests. In contrast to the results of Istiantoro, [14], the institutional ownership had a negative influence on the integrity of financial statements which showed that the greater ownership of institutions (insurance companies, banks, investment companies, etc.) could reduce the integrity of financial statements. On the other hand, if the institutional ownership is smaller, it could lead to greater integrity of financial statements. Meanwhile, the research from [23], [20] showed the result that institutional ownership did not affect the integrity of financial statements. Therefore, the formulation of the hypothesis is as follows:

H₂ : *Institutional ownership influences the integrity of financial statements*

F. Independent Commissioners

To face the challenge, the board of commissioners in every company should maintain a balance between the strategic formulation, policy-making and company performance in accordance with the supervision of directors and the accountability as well as the compliance with established [18]. Ref. [1] stated that independent commissioners are those appointed to be the representative of independent shareholders (minority shareholders) and these parties are not represented certain interests yet appointed based on solely their professional backgrounds of knowledge, experience, and expertise to fully carry out their duties in the company interests.

The existence of independent commissioners is expected to be neutral towards all policies made by the directors. This existence has been regulated by the Jakarta Stock Exchange (JSX) through the regulation of 'Kep-305 / BEJ / 07-2004' which requires

companies whose shares are listed on the JSX to represent an independent board of commissioners of at least 30% of all board members.

The research of [9], [24] presented a positive effect of the independent commissioners on the integrity of financial statements. Whereas, the study of [25] stated that independent commissioners had a negative effect. In addition, the study of [23], [32], [14], exhibited no effect from the independent commissioners on the integrity of financial statements. Therefore, the formulation of the hypothesis is as follows:

H₃ : *Independent commissioners influence the integrity of financial statements.*

G. Audit Committee

According to [30], the audit committee is a professional and independent working committee formed by the board of commissioners. Thus, their task is to assist and strengthen the function of the board of commissioners in carrying out the supervision functionality of financial reporting process, risk management, audit and implementation of the corporate governance in the company. The regulation from the Stated Owned Enterprises Ministry (PER-05/MBU/2006) concerning the ‘audit committee’ for state-owned enterprises (BUMN) stated that the audit committee is appointed and dismissed by the board of commissioners or supervisors which give a report to the General Meeting of Shareholders (GMS). The audit committee consists of at least one board member of the commissioners or supervisors, and at least two other members originating from outside of the enterprises.

Based on the Decree issued by the Chair of Financial Services Authority in Indonesia (SK BAPEPAM No.29/PM/2004) concerning the establishment and guideline of the Audit Committee's Work Implementation, each company audit committee must have at least one group member who has expertise in accounting and finance. This expertise is mandatory due to its main function as the audit committee to carefully evaluate the financial reporting process in the company. An accounting expert or financial management expert is someone who has an educational background in Accounting and Finance or has held important positions in Accounting or Finance [31].

The research of [21], [14] obtained results that audit committees had a positive effect on the integrity of financial statements because the greater the proportion of audit committee members will lead to greater integrity of financial statements. On the other hand, the smaller proportion of audit committee

members will lead to the reducing integrity of financial statements. This result is different from [24], [20] which showed that there was no influence between the audit committee on the integrity of financial statements. Therefore, the formulation of the hypothesis is as follows:

H₄ : *The Audit Committee influences the integrity of financial statements*

II. RESEARCH METHODOLOGY

A. Research Scope

This research was established based on the causal association relationship. The object of this research was manufacturers publicly listed on the Indonesian Stock Exchange from 2012 until 2016. Data were obtained from the website of [33].

B. Operational Variables

Integrity of Financial Statements

In this study, the proxy used to measure unconditional conservatism is a modification of the bias component proposed by [4], shown in the following equation:

$$MBV_{it} = \frac{\text{Stock Market Price}}{\text{Book Value Shares}}$$

in which,

MBV_{it} : *market to book value*

Market Capitalization : *stock price of the company ‘i’ per year end period*

Total Book Value : *total equity per share issued*

C. Managerial Ownership

Managerial ownership was measured by the percentage of shares owned by the board management to the total number of shares issued in the stock market (MOWV).

$$MOWV = \frac{\text{Number of shares owned by management}}{\text{Number of shares in stock}} \times 100\%$$

D. Institutional Ownership

Institutional ownership was measured by the percentage of shares owned by institutions to the total number of shares issued in the stock market (INST).

$$INST = \frac{\text{Number of shares owned by institutions}}{\text{Number of shares in stock}} \times 100\%$$

E. Independent Commissioners

The value of independent commissioner (KI) was measured by the percentage of independent commissioners to the total board of commissioners in the company structure.

$$KI = \frac{\text{Number of independent commissioners}}{\text{Total board of commissioners}} \times 100\%$$

F. Audit Committee

Audit Committee was measured by the percentage of audit committee members who have an educational background in accounting and finance (*financial expertise*).

$$AC = \frac{\text{Number of financial expertise members}}{\text{Total members of audit committee}} \times 100\%$$

Thus, the integrity model of financial statements was calculated using the following equation:

$$INT = \alpha + \beta_1 MOWN + \beta_2 INST + \beta_3 KI + \beta_4 KA + e$$

In which,

- INT : integrity model of financial report
- α : constant
- $\beta_1 \dots \beta_4$: regression coefficient
- MOWN : managerial ownership
- INST : institutional ownership
- KI : independent commissioner
- KA : audit committee

G. Population and Research Samples

The population stated in this study was all companies publicly listed on the Indonesian Stock Exchange (IDX) from 2012 to 2016. While the samples used in this study were manufacturers which meet the following criteria: (1) companies including manufacturers listed on the Stock Exchange during the study period, (2) these companies had issued and published their own complete annual reports for the year period of 2012-2016 and written in Rupiah/IDR (the Indonesian currency).

Based on those criteria set using the **purposive sampling** technique, **20 sample companies** were collected for the total **100 observation numbers** in the year period of 2012-2016. The results were listed on the following **Table 1**.

Table 1. Results of Sample Selection

| | |
|--|------------|
| Companies listed on the Indonesia Stock Exchange (2012-2016) | 129 |
| Companies not issuing Financial Reports (2012-2016) | (4) |
| Companies not using Rupiah (the Indonesian currency) | (24) |
| Companies with incomplete data | (81) |
| Total companies meeting the sample criteria | 20 |
| Numbers of Years of Observation Period | 5 |
| Numbers of Observation | 100 |

III. RESULTS AND DISCUSSION

The calculation results of the collected samples in this study were briefly illustrated in **Table 2** below.

Table 2. Results of Descriptive Statistics

| Variables | Mean | Std. Dev. | Min | Max |
|--------------|--------|-----------|-------|------|
| INT | 2.4243 | 1.16575 | 0.25 | 6.45 |
| MOWN | 0.0879 | 0.14727 | 0.00 | 0.89 |
| INST | 0.5039 | 0.19911 | 0.08 | 0.87 |
| KI | 0.3631 | 0.05834 | 0, 25 | 0.50 |
| KA | 0.5017 | 0.16999 | 0.25 | 0.67 |
| Observations | 100 | | | |

Abbreviation:

INT: Financial Report Integrity, **MOWN:** Managerial Ownership, **INST:** Institutional Ownership, **KI:** Independent Commissioners, **KA:** Audit Committee.

Based on **Table 2** above, descriptive statistics for financial statement integrity (INT) were described as a minimum value of 0.25, a maximum value of 6.45 with an average of 2.4243 and a standard deviation value of 1.16575. Managerial ownership (MOWN) obtained a minimum value of 0.00, a maximum value of 0.89 with an average of 0.0879 and a standard deviation value of 0.14727. Institutional ownership (INST) resulted in a minimum value of 0.08, the maximum value of 0.87 with an average of 0.5039 and standard deviation value of 0.19911. Independent Commissioner (KI) showed a minimum value of 0.25, the maximum value of 0.50 with an average of 0.3631 and a standard deviation value of 0.05834. The audit committee (KA) had a minimum value of 0.25, a maximum value of 0.67 with an average of 0.5017 and a standard deviation value of 0.16999. Audit quality produced a minimum value of -1.03, a maximum value

of 0.97 with an average of 0.0017 and a standard deviation value of 0.18235.

Table 3. Results of The Regression Test

| INT = 3.336+ 2.260 (MOWN) + 0.620 (INST) - 0.868 (KI) - 2.200 (KA) | | | | |
|--|-------------------|--------------------|-------------|---|
| Variables | Prediction | Coefficient | Sig. | |
| Constant | | 3.336 | 0.000 | |
| MOWN | + | 2.260 | 0.001 | * |
| INST | + | 0.620 | 0.230 | |
| KI | + | -0.868 | 0.580 | |
| KA | + | -2.200 | 0.000 | * |
| F-Statistic | 16.216 | | | |
| Sig(F-Statistic) | 0.000 | | | |
| Adj.R-Square | 0.435 | | | |
| Description: | | | | |
| Significance: for alpha 5%* | | | | |
| INT: <i>Financial Report Integrity</i> , MOWN: <i>Managerial Ownership</i> , INST: <i>Institutional Ownership</i> , KI: <i>Independent Commissioners</i> , KA: <i>Audit Committee</i> | | | | |

Table 3 illustrated that the amount of the adjusted R-Square was obtained at the value of 0.435 or 43.5%. It shows that the influence levels given by managerial ownership, institutional ownership, and independent commissioners were as much as 43.5%. Meanwhile, the remaining value of 56.5% was likely affected by other factors which were not examined in this study. From **Table 3**, it was also shown that the value of F-count was higher than of F-table (16.216>2.310) with the significance of 0.00<0.05. It can be assumed that managerial ownership, institutional ownership, independent commissioners, and audit committee collectively influenced the integrity of financial statements.

The regression test presented the managerial ownership factor that had the value of T-count was higher than of T-table (3.374>1.98552) with the significance level of 0.01<0.05 so that the first hypothesis (H1) could be accepted. The resulting beta coefficient was 2.260, signaling a positive direction. These results proved that managerial ownership had a positive impact on the integrity of financial statements. The results of this study support the results of the previous study conducted by [32], [24], which also exhibited the positive effect of the managerial ownership factor. By the greater value of the managerial ownership, the board management will be more responsible in order to improve the company performance. Since increasing company profits will also impact on the increase of incentives received by the board management. It can be concluded that the

management will provide financial statements accountability so that it can improve the integrity of financial statements.

The results of the regression test in **Table 3** found that the institutional ownership had a lower value of t-count than of t-table (1.209 <1.98552) with the significance level of 0.230 > 0.05. It means that the second hypothesis (H2) was rejected. The resulting beta coefficient of 0.602 had proved that the institutional ownership factor had no significant effect on the integrity of financial statements. The results of this study support the results of the previous study conducted by [9], [24], [25], [20], which had shown that institutional ownership could not affect the integrity of financial statements because institutional owning large shareholdings in the company do not necessarily want their roles in controlling the company, so that it is less effective in the monitoring process of company management. In consequence, the opportunistic behavior of the management can increase, in which it can reduce the integrity of financial statements.

Based on **Table 3**, the regression test results also presented the value of the independent commissioners whose it's t-count was lower than its t-table (-0.556 <1.98552) with the significance level of 0.580 > 0.05, thereby suggesting that the third hypothesis (H3) was rejected. Whereas, the value of the beta coefficient of -0.86 illustrated a negative direction. Thus, it can be assumed that the number of independent commissioners has also no effect towards the integrity of financial statements. The results of this study support the results of the previous study conducted by [14], [32], showing that there is no influence from the independent commissioners on the integrity of financial statements. Both large and small numbers of independent commissioners are not necessarily effective in supervising corporate governance. Therefore, the increasing number of independent commissioners is not certainly able to increase the effectiveness of the company monitoring process. This will, then, reduce the integrity of financial statements.

The results of multiple linear regression test from this study also exhibited the audit committee value of t-count (-4.149) was higher than t-table (1.98552) with the significance level of 0.000 < 0.005. This result indicated that the fourth hypothesis (H4) could be accepted. The beta coefficient value of -2,200 was in a negative direction so that it can be assumed that the audit committee has a negative effect on the integrity of financial statements. These results support the results of the previous research conducted by [25] which had shown that the factor of audit committees

negatively affect the integrity of financial statements. Increasing the number of audit committee does not necessarily improve the functionality of the audit committee in a company. In other words, the ineffectiveness of the audit committee will reduce the integrity of financial statements.

IV. CONCLUSIONS

The results of this study indicated several factors that can affect the integrity of financial statements. Of the five factors studied (managerial ownership, institutional ownership, independent commissioners, and audit committee), it was approved that managerial ownership and audit committees could affect the integrity of financial statements. It means that the high percentage of the managerial ownership can improve the integrity of financial statements.

On the other hand, increasing the audit committee (the high number of experts in finance and auditing) has no direct correlation in improving the functionality of the audit committee in a company. The ineffectiveness of the audit committee will have an impact on the reducing integrity of financial statements due to its negative coefficient direction on the integrity of financial statements.

Moreover, other factors, namely institutional ownership and independent commissioners have been approved to have no effect on the integrity of financial statements. This means that there is less effect on the factors of institutional ownership and independent commissioners in the company in order to increase the integrity of financial statements.

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