

# Effect of Corporate Governance Mechanism on the Quality Financial Reporting

## (Evidence in Indonesia and Singapore)

Lies Zulfiati, Angga Pratama Putra

Department of Accounting  
Sekolah Tinggi Ilmu Ekonomi Indonesia Jakarta  
Jakarta, Indonesia  
lies.zulfiati@yahoo.com

**Abstract**—This electronic document is a “live” template and already define This study aimed to analyze the influence of corporate governance mechanisms (by proxy of the board of directors and independent board, audit committee, the quality of KAP big 4, specialization auditors, and corporate governance country level) on the quality of financial reporting to the control variable leverage, size, and GDP companies the sub-sectors energy, raw materials, industrial, consumer discretionary, information and technology, essential goods, health, telecommunications services listed on the Indonesia Stock Exchange and the Singapore Stock Exchange 2010-2013. The method of analysis in this research is descriptive method with multiple linear regression approach and hypothesis test to test coefficient of determination, and partial regression coefficient. Selection of the sample through purposive sampling method. There are 31 companies in Indonesia and 41 companies in Singapore companies that have met the criteria in the sample research. The data used is secondary data. The results of this study prove that the board of directors and independent board, KAP Big 4 audit quality and corporate governance country level a significant effect on the quality of financial reports while the audit committee and the audit specialization did not significantly affect the quality of the financial statements.

**Keywords**—*corporate governance country level; quality of financial statements; specialization auditor; the audit committee*

### I. INTRODUCTION

The financial statements are a financial description of a company, therefore, in the process of making the financial statements presented indicate the correct and honest information is the definition of the quality of financial statements [1], Enron case of large companies in the United States describes the phenomenon of profit manipulation scandal involving internal company [2]. Developing countries like Indonesia are also not spared from cases of financial report manipulation such as PT Kimia Farma Tbk. and PT Lippo Tbk. [3]. The costs incurred as a result of corporate governance is poor largely borne by minority shareholders, one way to increase the confidence of investors is to have governance practices of good corporate governance that can cause report better finance and more transparent business disclosure and reporting [4].

The existence of an independent board of commissioners is expected to minimize the practice of earnings management because the board of independent commissioner serves as a separator of interests between shareholders and management. The government through Bapepam-LK issued a new regulation, namely the Decision of the Chairman of Bapepam-LK. Kep-643 / BL / 2012. The rules indicate the need for a more competent audit committee and the role of the audit committee in ensuring the quality of the company's financial statements becomes increasingly needed.

The audit quality of public accountants can be seen from the size of the audit firm's KAP. KAP large (Big 4 accounting firms) are believed to audit more qualified than the small KAP (Non-Big 4 accounting firms) [5]. Owned geographical coverage is also broader than the small KAP (not affiliated with KAP Big 4) so that it can produce better audit quality [6]. Specialization auditors also provide higher quality audit of the auditor without specialization in a particular industry [7]. The specialist auditor describes the auditor's expertise and audit experience in a particular industry field.

Agency theory stating their employment relationship between the parties authorizing (the principal) is investor and a party receiving authority (agency) is the manager [8]. Corporate governance arises because there is a separation between the ownership control of the company, or often known as agency problems. Corporate governance is needed to reduce the agency problem between owners and managers [9]. Corporate governance mechanism in this study are independent board, board of directors, audit committee, audit quality Big 4 accounting firm, auditor specialization, corporate governance country level.

In measure the effective independent board is in the range of more than five and less than 14 people [10]. The board of directors in a company will determine the policies to be taken or short-term corporate strategy and long-term [11]. The audit committee in charge of reviewing the accounting policies adopted by the company, assessing internal controls, reviewing external reporting systems and regulatory compliance, is expected to improve the quality of its financial statements.

Previous research revealed that audit quality measured by KAP size has no effect significant to the integrity of financial statements [12]. But inversely is getting bigger the higher the KAP the quality of the resulting financial statements [13]. This matter because the big KAP has an incentive to avoid the things that can damaging his reputation. Specialist auditors have better knowledge and understanding of the client's business characteristics than non-specialist auditors. Specialist auditors are also more likely to detect errors and irregularities that occur in financial statements, so as to assist companies in providing better earnings information and quality of financial statements.

Another previous research revealed which declared state-level corporate governance has a positive correlation to the performance of the company [14]. This is also depending on the legal context in which countries whose laws are commonly targeted Protection against misuse of management and state civil law target protection against counterfeit Shareholder misuse. Based on the description above, the fifth hypothesis to be tested in this study are:

- H1: The board of directors and independent board take effect to quality of financial statements.
- H2: Committee of the audit affect the quality of financial reporting.
- H3: Audit quality affects the quality of financial reporting.
- H4: Auditor specialization of different audit affect the quality of financial reporting.
- H5: Corporate governance level country affect the quality of financial reporting.

**II. METHOD**

*A. Research Design*

The population used in this study are all companies' sub-sectors energy, raw materials, industrial, consumer discretionary, information and technology, essential goods, health and telecommunications services listed in the Indonesia Stock Exchange (BEI) and the Singapore Exchange (SGX) years 2010 to 2013. The sample used in this study using purposive sampling technique, there are 31 Indonesian companies and 41 companies of Singapore who meet the criteria sampling.

Ideally financial statements should reflect an accurate picture of the company's financial condition and performance. The information should be useful for assessing the past and the future [15]. Based on Equation. 1, the quality of financial reporting in this study was measured using the proxy of financial statements from other studies [16].

$$WCA_{i,t} = \beta_0 + \beta_1 CFO_{i,t-1} + \beta_2 CFO_{i,t} + \beta_3 CFO_{i,t+1} + \epsilon_{i,t} \tag{1}$$

WCA<sub>i,t</sub> = accrual working capital calculated from changes in current assets are reduced changes in current liabilities

CFO<sub>i,t</sub>, CFO<sub>i,t</sub>, and CFO<sub>i,t+1</sub> = Cash flow from operation calculated from differences in net profit before outside post regular and total accruals.

Whereas the independent variables in this study are:

- Board of Directors / Board of Commissioners, independent non-executive, Board composition >= 50% score = 1, composition of the board of the non-independent non-executive <50% score = 0
- Audit Committee, if company has audit committee score = 1, If does not have audit committee score = 0
- KAP Big 4 auditor quality, if a company is audited by KAP Big 4 choir = 1, if audited by the accounting firm other than the BIG 4, Score = 0
- Auditor specialization, if the firm control of >= 10% market share = 1, if KAP not mastered >= 10% market share = 0
- Corporate governance country level, watch CG percentage per year

Besides, variable control in this study are:

- Leverage is the total debt divided by total assets.
- Size (Size of the company), calculated by the logarithm of total assets.
- Gross Domestic Product (GDP), taken from the World Bank websites.

*B. Classic Assumption Test Result*

Firstly, based on Table I, the test results indicate normality Kolmogorov-Smirnov Z value of 0.948 is greater than 0.05 (0.948 > 0.05) and Asymp Sig value 0.330 (> 0.05) were significantly greater than 0.05 (0.330 > 0, 05) so that it can be concluded the data in the researcher's residual distributed normally.

TABLE I. NORMALITY TEST RESULT

| One-Sample Kolmogorov-Smirnov Test |                       |                                |
|------------------------------------|-----------------------|--------------------------------|
|                                    |                       | <i>Unstandardized Residual</i> |
| N                                  |                       | 288                            |
| Normal Parameters <sup>a,b</sup>   | <i>Mean</i>           | 0E-7                           |
|                                    | <i>Std. Deviation</i> | ,96266459                      |
| Most Extreme Differences           | <i>Absolute</i>       | ,056                           |
|                                    | <i>Positive</i>       | ,056                           |
|                                    | <i>Negative</i>       | -,033                          |
| Kolmogorov-Smirnov Z               |                       | ,948                           |
| Asymp. Sig. (2-tailed)             |                       | ,330                           |

Secondly, based on Table II, the result calculation of the VIF (Variance Inflation Factor) also shows the overall value of the variable board of directors and board of commissioners (BOD\_BOC), the audit committee (KOM\_AUD), quality KAP Big 4 (KAP\_BIG4), Specialization Auditor (SPES\_AUD), Corporate Governance Country Level (CG\_COUNTRY) on the quality of financial statements (FRQ) with a control variable leverage (LEV), Size, and gross domestic product

(GDP) below 10 ( $\leq 10$ ). Thus, it can be concluded that the model does not experience interference multicollinearity.

TABLE II. RESULT MULTICOLLINEARITY TEST

| Model |            | Collinearity Statistics |       |
|-------|------------|-------------------------|-------|
|       |            | Tolerance               | VIF   |
| 1     | (Constant) |                         |       |
|       | BOD_BOC    | ,649                    | 1,541 |
|       | KOM_AUD    | ,988                    | 1,012 |
|       | KAP_BIG4   | ,635                    | 1,574 |
|       | SPES_AUD   | ,791                    | 1,265 |
|       | CG_COUNTRY | ,292                    | 3,419 |
|       | LEV        | ,843                    | 1,187 |
|       | SIZE       | ,314                    | 3,190 |
|       | GDP        | ,684                    | 1,462 |

Thirdly, based on the Table III, the results obtained from the autocorrelation test using the Durbin-Watson test (DW test) show that the DW value is 1.901. The value of 4 is less the upper limit (4 - dU) of 2,145 and the value 4 is reduced by the lower limit (4 - dL) by 2,242. While the value of 4 minus DW (4 - DW) is 2.099. From the foundation of a predetermined decision, if  $1,901 > 1.855$  then no there is positive autocorrelation and also if  $2.099 > 1.855$  then there is no negative autocorrelation. Based on these results, then it can be concluded on the regression analysis no there autocorrelation.

TABLE III. RESULT AUTOCORRELATION TEST

| Model | R                 | R Square | Adjusted R Square | Std. Error of the Estimate | Durbin-Watson |
|-------|-------------------|----------|-------------------|----------------------------|---------------|
| 1     | ,646 <sup>a</sup> | ,398     | ,378              | ,43322                     | 1,901         |

III. FINDINGS AND DISCUSSION

The correlation coefficient indicates the number 0,646 means that corporate governance has amounted to 64.6% in relation to the of the board of directors and the board of directors, audit committee, the quality of the Big 4 accounting firm auditor specialization, corporate governance country level, leverage, Size, and GDP. Based on the Table IV, the adjusted value of R<sup>2</sup> (coefficient of determination) shows the number 0.378. This means the board of directors and the board of directors, audit committee, the quality of the big four accounting firm, auditor specialization, corporate governance country level, leverage, Size, and GDP is able to explain the quality of financial reporting at 3.78%, while the remaining 96.22% can be explained variable others. This result is caused by other variables that are more powerful in influencing the quality of financial statements. In addition, such results are possible due to the use of less valid measurement methods.

TABLE IV. THE RESULTS COEFFICIENT DETERMINATION TEST

| Model | R                 | R Square | Adjusted R Square | Std. Error of the Estimate |
|-------|-------------------|----------|-------------------|----------------------------|
| 1     | ,646 <sup>a</sup> | ,398     | ,378              | ,43322                     |

Based on the result of t test from Table. V, the decision can be made as follows:

- The board of directors and independent board of commissioners (BOD\_BOC) has a significant value of 0.013 less than the 0.05 significance ( $0.013 < 0.05$ ). It can be concluded that the variables of the independent board of commissioners partially affect the quality of financial statements (FRQ). Thus, the H1 of the "board of directors and independent board of commissioners affects the quality of financial reports" received.
- Audit committee variable (KOM\_AUD) has a significant value of 0.781 greater than the significance of 0.05 ( $0.781 < 0.05$ ). It can be concluded that the audit committee variables partially affect the quality of financial statements (FRQ). Thus, H2 on "audit committee to influence the quality of financial statements" "rejected.
- Variable KAP Big 4 audit quality (KAP\_BIG4) have significant value of 0.022 is less than 0.05 ( $0.022 < 0.05$ ). It can be concluded that the variable Quality Audit KAP Big 4 partially affect the quality of financial statements (FRQ). Thus, H3 of the "Big 4 accounting firm audit quality affects the quality of financial reports" "received.
- Auditor specialization variable (SPES\_AUD) has a significant value of 0.488 greater than the significance of 0.05 ( $0.488 < 0.05$ ). It can be concluded that the auditor specialization variables partially affect the quality of financial statements (FRQ). Thus, H4 of "auditor specialization affects the quality of financial statements" rejected.
- Variable Corporate governance country level (CG\_COUNTRY) have significant value of 0.000 is less than 0.05 ( $0.000 < 0.05$ ). It can be concluded that the variables of corporate governance country level partially affect the quality of financial statements (FRQ). Thus, H5 about "corporate governance country level" affect the quality of financial reports "received.

TABLE V. RESULT PARTIAL TEST (T TEST)

| Model       | Unstandardized Coefficients |            | Standardized Coefficients | t      | Sig. |
|-------------|-----------------------------|------------|---------------------------|--------|------|
|             | B                           | Std. Error | Beta                      |        |      |
| (Constant)  | -1,790                      | ,424       |                           | -4,220 | ,000 |
| BOD_BOC     | ,304                        | ,121       | ,156                      | 2,500  | ,013 |
| KOM_AUD     | ,086                        | ,309       | ,014                      | ,278   | ,781 |
| KAP_BIG4    | ,150                        | ,065       | ,145                      | 2,309  | ,022 |
| SPES_AUD    | -,059                       | ,085       | -,039                     | -,695  | ,488 |
| CG_COUNTR Y | 1,964                       | ,317       | ,575                      | 6,197  | ,000 |
| LEV         | ,048                        | ,108       | ,024                      | ,446   | ,656 |
| SIZE        | ,090                        | ,010       | ,769                      | 8,586  | ,000 |
| GDP         | ,666                        | ,288       | ,140                      | 2,310  | ,022 |

#### IV. CONCLUSION

In the Conclusion, the first hypothesis states that the board of directors and independent board of commissioners affect the quality of financial statements in companies at manufacturing companies listed on the Stock Exchange 2010-2013. After calculation using SPSS 22 obtained partial significant value of 0.013 is smaller than the significance of 0.05 ( $0.013 < 0.05$ ). The results of this study are consistent with previous research that states the board of directors and independent board of commissioners have a significant effect on the integrity of the financial statements [17].

The second hypothesis states that the audit committee does not affect the quality of financial statements in the company at manufacturing companies listed on the Stock Exchange 2010-2013. After calculation using SPSS 22 obtained significant value 0.781 partial larger than the significance of 0.05 ( $0.781 < 0.05$ ). The results of this study are consistent with previous research, which show the result that the existence of the audit committee body is less effective because the number of audit committees within the company has not been able to maximize its function in accounting practice [18]. The existence of the agency is allegedly only doing a review of financial and accounting information to be issued by the company, but not directly involved in the settlement of financial problems faced by the company.

The third hypothesis states that KAP Big 4 audit quality affects the quality of the financial statements in the company on the companies listed on the Stock Exchange 2010-2013. After calculation using SPSS 22 obtained partial significant value of 0.022 is smaller than the significance of 0.05 ( $0.022 < 0.05$ ). Then the quality of financial statements will be higher and also have more incentive to avoid things that can damage its reputation compared with that is not a Big 4 accounting firm. The results of this study are consistent with previous research, which shows the results of that audit quality Big 4 accounting firm affect the integrity of the financial statements which refers to the quality of a good corporate financial statements [19].

The fourth hypothesis states that the auditor specialization does not affect the quality of financial statements at manufacturing companies listed on the BEI 2010-2013. After calculation using SPSS 22 the partial significant value of 0.488 is greater than the significance of 0.05 ( $0.488 < 0.05$ ). The result of this research is consistent with previous research that shows that the auditor's specialization has no significant effect on the profit management which refers to the quality of the poor financial report [20].

The fifth hypothesis states that corporate governance country level affects the quality of financial statements in companies in manufacturing companies listed on the BEI 2010-2013. After calculation using SPSS 22 obtained partial significant value of 0.000 smaller than the significance of 0.05 ( $0.000 < 0.05$ ). The results of this study are consistent with previous research study [14].

The company should continue to make efforts in improving the quality of the company's financial statements as reflected in the company's financial statements. Based on these results, the

factors that affect the quality of financial reporting is the board of directors and independent board of commissioners, KAP Big 4 audit quality and corporate governance country level. Therefore, companies should retain the board of directors and independent board of commissioners This is because the function of the board of directors are fully responsible for the management of companies in which each of the directors can take the right decisions and carry out tasks according to the division of tasks and authority, while the commissioners showed oversight conducted capable influence the behavior of managers in an effort to improve the performance of companies that can produce good quality financial reports. In addition, the company if audited by Big 4 accounting firm, then the quality of financial statements will be better and also have more incentive to avoid things that can damage its reputation compared with that is not a Big 4 accounting firm. Corporate governance country level is one of the keys to the success of the company to grow and benefit in the long run, while winning global business competition.

This study give implication for users of financial statements should in taking investment decisions not only focused on financial information. Investors can look at aspects other information such as the application of the mechanism of corporate governance within the company as one of the considerations of investment decisions. This is because the role of the company's corporate governance mechanism will provide short-term benefits and long-term and can increase the value for shareholders and stakeholders. Improving the quality of financial statements also means minimizing profit management practices undertaken by the company. Thus, the financial statements generated by the company really provide benefits for users of these financial statements.

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