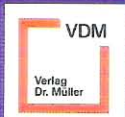




Anis Chariri

The Dynamics of Financial Reporting Practice in an Indonesian Company

A Reflection of Javanese Views on an Ethical Social Relationship



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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

1.1.1 Lack of Convincing Evidence

Financial reporting is purported to be a useful mechanism for managers to communicate with outside parties such as investors, creditors and financial analysts. From the perspective of usefulness to decision making, financial reporting should be able to present useful information to help investors and creditors make economic decisions. This perspective is consistent with the objectives of financial reporting proposed by authoritative bodies such as the US Financial Accounting Standard Board (FASB) in the Statement of Financial Accounting Concepts (SFAC No. 1) and the Australian Accounting Research Foundation (AARF) in the Statement of Accounting Concepts (SAC No. 1).

Usefulness to decision making implies that to provide the information users need, a manager, as a preparer of financial reports, should be able to communicate the information and safeguard its relevance and reliability. The relevant and reliable information supplied by financial reporting can also have significant effects for companies and for public confidence in capital markets (Bromwich 1992; Miller and Bahnson 2002). However, whether financial reporting is capable of providing sufficient and appropriate information to help users make economic decisions is questionable.

Conflicts of interests between managers and outside parties, especially investors, create distortions in financial reports. In fact, through “creative ways”, managers are capable of manipulating accounting numbers to achieve their own objectives (Clarke, et al. 2003; Jennings 2003; Pijper 1993). This usually occurs when there is divergence in shareholders’ and managers’ objectives. Such divergence could motivate managers to make financial reporting decisions in their own interest and could provide incentives to distort reported profits (see Dye 1988; Schipper 1989; Watt and Zimmerman 1986). Some studies also provide evidence supporting this argument (Collins and DeAngelo 1990; Healy 1985; McNichols and Wilson 1988). As a result, financial reporting has been the subject of serious criticism in recent years.

The public has witnessed a number of well-known examples of accounting scandals and bankruptcy involving large and prestigious companies in developed countries. The media has reported scandals and bankruptcies in companies such as Sunbeam, Kmart, Enron, Global Crossing (USA), BCCI, Maxwell, Polly Peck (UK) and HIH Insurance (Australia). Besides scandals in developed countries, which have sophisticated capital markets and regulations, similar cases can be also seen in developing countries with emerging capital markets. As reported by Johnson, et al. (2000), Asian countries have experienced similar cases, such as PT

Bank Bali, and *Sinar Mas Group* (Indonesia), Bangkok Bank of Commerce (Thailand), United Engineers Bhd (Malaysia), Samsung Electronics and Hyundai (Korea).

These cases imply that the corporations have failed to supply accurate information to their investors, and to provide appropriate disclosures of any transactions that would impact their financial position and operating results. Indeed, information provided in financial reports can be misleading. Accordingly, investors and other users of financial reports are raising questions about the quality and integrity of the financial reporting process (Dunn 2003) and about the usefulness of financial reports in helping investors make economic decisions.

In addition, the recent accounting scandals have induced a crisis of confidence in financial reporting practice and effectiveness of corporate governance mechanisms (Bartley 2002; Browning 2002; O'Connell, et al. 2005). A number of surveys point out that annual financial reports are not widely read by users nor used as the main source for making economic decisions (Anderson 1979; Anderson and Epstein 1995; Bartlett and Chandler 1997; CPA Australia 2002). Meanwhile, other studies have been directed towards investigating how to enhance the quality of financial reporting (Cohen, et al. 2004; Jonas and Blanchot 2000) and how information provided by financial reports affects market efficiency and individual behaviour (Amir and Lev 1996; Healy, et al. 1999; Lev and Ohlson 1982; Lev and Zarowin 1999).

Studies of financial reporting, as Mathews and Perera (1993); Ryan, et al. (2002) and Wolk, et al. (2004) note, have proceeded in several directions, such as a decision-usefulness approach (Gilman 1939; Grady 1965; Paton 1922; Paton and Littleton 1940), behavioural research (for example, Anderson 1979; Anderson and Epstein 1995; Chenhall and Juchau 1977; Lee and Tweedie 1975a; 1975b) and market-based accounting research (for example, Amir and Lev 1996; Botosan 1997; Francis and Schipper 1999; Healy 1985; Healy, et al. 1999; Lev and Ohlson 1982; Lev and Zarowin 1999). Moreover, studies of financial reporting have been dominated by the positive accounting research paradigm framework, which addresses particular problems to be analysed using mathematical and statistical techniques, and which is aimed at explaining and predicting how self-interested individuals behave when facing economic consequences of particular accounting issues (Holthausen 1990; Watt and Zimmerman 1986). Studies of financial reporting have also raised concerns about the roles of corporate governance mechanisms, auditors and regulators in monitoring managers' behaviour (Berle and Means 1975; Cohen, et al. 2004; Fama and Jensen 1983; Forker 1992; Jensen 1986; Jensen and Meckling 1976; Weir, et al. 2002; Williamson 1985b).

However, empirical studies have not provided conclusive and convincing evidence to support the claims made for the usefulness of financial reporting. For example, findings of empirical studies on the association between a corporate governance mechanism and quality financial reporting showed contradicting evidence (see for example, Beasley 1996; Beasley, et al. 2000; Chen and Jaggi 2000; Dunn 2003; 2004; Forker 1992; Goodwin and Seow 2002). The studies produced different results, but they did not provide conclusive and convincing explanations for such different findings.

There might be some reasons for the mixed evidence. One might be that the nature of instruments used to measure variables affecting transparent financial reporting is based on a proxy, such as the presence of an independent board of directors and audit committee, the

proportion of their independent members and the size of the board or committee. Therefore, such different measures could result in different conclusions. Watt and Zimmerman (1986) also have acknowledged that the application of vague proxies, different sample sizes, and incorrectly specified functional models have produced inconclusive and mixed results. The differences in research findings might also be because of differences in the time period of the studies or the cultural environment of countries (Adams and Kuasirikun 2000; Chen and Jaggi 2000; Hofstede 1987; Perera 1989), and the cultural uniqueness of organisations (Geriech 2003; Loebbecke, et al. 1989; Merchant 1987; Rezaee 2002).

It has been argued that the presence of a corporate governance mechanism does not guarantee transparent financial reporting practice (Fogarty and Kalbers 1998; Tricker 1994a). The effectiveness of a control mechanism depends on values, norms and beliefs accepted in an organisation (Jennings 2004a; 2004b; 2005a; Oliver 2004) and the involvement of actors in control structures in monitoring managers (Cohen, et al. 2004; Jennings 2005b). However, none of those studies tries to analyse financial reporting practice from a perspective of the power exercised by actors in the corporate governance structure, and institutional factors such as regulations and rules. This might be because of the commonly made claim that accounting is merely concerned with matters of fact and efficiency. Tinker (1988) contends that problems of accounting are associated with the way in which marginalist economics has colonised the notion of efficiency. This implies that accounting is seen as representation of “itself, variously, as ‘technical’, ‘neutral’, and ‘value free’” (Munro 1998, p. 201).

However, accounting is no longer seen by some as “a neutral device that merely documents and reports ‘the facts’ of economic activity” but as “a set of practices that affects the type of the world we live in, the type of social reality we inhabit” (Miller 1994, p. 1). Financial reporting practice is influenced not only by economic variables as claimed by the proponents of positive research, but also by institutional, political and cultural environments. It is recognised that the current research in accounting and corporate governance is alert to the fact that actors’ behaviour is modified by procedures, rules, incentives and other economic factors. Most research to date has all but ignored the institutional, political and cultural environment in which financial reporting practice takes place. Consequently, calls for studying financial reporting within its environmental contexts have emerged in accounting literature (Adams 1997; Gray 1988; Rezaee 2002; Miller 1994; Munro 1998).

1.1.2 The Need for Further Study

Considering the above view, a further study is necessary to understand and analyse the dynamics of financial reporting practice from the perspective of a corporate governance mechanism involving institutions, power and culture. Such research should be directed to understand how power is exercised by actors in a corporate governance mechanism, and how institutional pressures and organisational beliefs, values, and norms influence financial reporting practice of a company.

The above views insinuate that financial reporting practice should be studied within the framework of an interpretative, rather than a positivist, paradigm. Such a study is attainable because accounting can shape and be shaped by the environment in which it takes

place, and because accounting procedures are intertwined with interpretation and understanding (Mouck 1992). Indeed, managers and other organisational actors who construct financial reporting are both influenced by and influence the environment (Mangos and Lewis 1995). Moreover, Hopper, et al. (1995, p. 528) highlight that “...in communicating reality accountants simultaneously construct it (Hines 1988) and accounting is a social practice...and not merely a market practice guided by equilibrium in an efficient market”. Hopwood, et al. (1994, p. 228) also claims that “...*accounting* is intimately implicated in the construction of facilitation of the contexts in which it operates. It cannot be extracted from its environment like an individual organism from its habitat”[original emphasis].

Studying financial reporting practice from the perspective of institutions, power and culture can enhance prior studies of financial reporting practice that have been focused on technical and economic issues. Cooper (1980) and Tinker (1980) insist that the scope of accounting research should be broadened beyond traditional positivist investigations with its technical-efficiency focus to incorporate social and political phenomena. In a similar vein, Neu (1992) argues that accounting studies should go beyond the traditional positivist investigation to encompass socio-political factors.

More recently, Geriessh (2003) and Cohen, et al. (2004) also suggest that further research of financial reporting should focus on the political, social, and cultural forces that influence accounting decisions. These views are shared by Hopwood, et al. (1994, p. 228) who opine that “accounting cannot be isolated and analysed as practice that is free from culture. The existence of accounting is determined by culture, customs, norms, and institutions”.

To date, what has been studied in accounting is how power and institutions influence individual behaviour in decision making within a management accounting framework, such as in budgeting (Bartlett 1980; Covaleski and Dirsmith 1986; Pfeffer and Salancik 1974), and how power and culture affects interested parties in accounting standard setting, such as those of the US (Puro 1984; 1985; Sutton 1984; Tandy and Wilburn 1992; 1996), the UK (Hope and Gray 1982; Nobes 1991; Sutton 1984), Australia (Klumpes 1994; Walker and Robinson 1993; 1994), New Zealand (Rahman, et al. 1994) and Germany (McLeay et al. 2000). What is missing from the prior studies is research into the relation between institutions, power and culture in financial reporting practice of an organisation.

The argument in this study is built on a belief that accounting is a socially constructed reality (Hines 1988; Miller 1994; Morgan 1988; Munro 1998; Neimark and Tinker 1986). In line with financial reporting, such practice involves interactions among organisational actors; and between the actors and external institutional environment/constituents. It is the institutional environment that shapes financial reporting practice, and it is the people who process information, make judgment and decisions regarding information presented in financial reports. This means that corporate financial reporting is a dynamic process—a continuous conversation.

This study claims that financial reporting practice is an institutional and political practice concerning the supply of information, and that it takes place in a political arena involving rules of the game (regulations/rule), culture and players (interested parties). As Guthrie and Parker (1990, p. 166) argue

the political economy perspective perceives accounting reports as social, political and economic documents. They serve as a tool for constructing, sustaining and legitimising economic and political arrangements, institutions and ideological themes.

In addition, Baker and Bettner (1997, p. 293) point out that

accounting capacity to create and control social reality translates into empowerment for those who use it. Such power resides in organisations and institutions, where it is used to instil values, sustain legitimising myths, mask conflict and promote self-perpetuating social orders...Contrary to the public opinions, accounting is not a static reflection of economic reality, but rather is highly partisan activity.

Accordingly, the dynamics of financial reporting practice might be better understood by analysing how players behave in organisations according to norms, values and beliefs accepted in the organisation, and how external institutional pressures influence the actors in financial reporting practice.

Within the mechanism of corporate governance, at least, five players are involved in making judgments on financial reporting: managers, boards of directors, audit committees, internal auditors and external auditors. However, it can be argued that owners, especially controlling shareholders or founders (mostly in developing countries) might also be intensively involved in determining the information disclosed in financial reports. Even so, it is believed that although all players may have convergent objectives, power in organisations tends to be dominated by managers. Crowther (2002, p. 44 note 5) argues that:

when considering power in the context of a disciplinary practice of surveillance (Foucault 1977) through the use of the reporting mechanisms of accounting, it is clear that the majority of power resides in the managers of the organisations who control and distribute this reporting to other stakeholders in the manner they choose. It is recognised however that legislative and regulatory requirements provide a limit to their ability to control this information and pose demands upon the reporting framework.

The previous examples of accounting scandal and bankruptcy, such as Enron and HIH Insurance, showed that boards of directors, audit committees and external auditors seem unable to monitor and supervise managers to act in the interest of shareholders (Fox 2003; HIH Royal Commission 2003; Miller and Bahnson 2002).

Further, a study of the dynamics of financial reporting practice by involving institutions, power and culture could make a significant contribution to studies on financial reporting practice. This is because such a study could provide insights into how institutional pressures and culture influence financial reporting practice, and how power is distributed and exercised by actors in an organisation to determine contents, formats and disclosures of financial statements and explain why certain companies are committed to quality financial reporting. The only studies considering power in financial reporting are those by Dunn (2004), Fogarty and Kalbers (1998) and Kalbers and Fogarty (1993); whereas a study concerning institutional aspects of financial reporting was undertaken by Mezas (1990).

However, Dunn (2004) only investigated power from insider perspectives and found that the decision to issue fraudulent financial reports is more likely to occur when there is a

concentration of power in the hands of insiders. On the other hand, studies by Fogarty and Kalbers (1998) and Kalbers and Fogarty (1993) only considered power of the audit committee and neglected how power is exercised and mobilised in an organisation to influence financial reporting practice.

In relation to institutional aspects, Mezas (1990) only investigated the influence of institutional variables on the recording of the income statements for financial reporting purposes of the investment tax credit (the use of the flow-through method versus the deferral method). This study neglected a social and political process by which a certain method was adopted.

Studies by Fogarty and Kalbers (1998) and Kalbers and Fogarty (1993) concluded that it is difficult to measure power and suggested that research should be undertaken by using an indepth interview approach; whereas Mezas' (1990) study suggested that further work in an institutional setting is required to improve understanding of institutional effects on organisations. Such suggestions imply that studies of financial reporting practice within its environmental context should employ a qualitative approach and should be conducted in an organisational setting.

1.2 THE REASON FOR A STUDY IN AN INDONESIAN SETTING

1.2.1 A Lot of Regulations but Weak in Law Enforcement

Indonesia is the world's largest archipelago, the world's fourth-largest nation, and its population consists of different ethnic groups including Javanese (45 per cent) Sundanese (14 per cent), Madurase (7.5 per cent) and coastal Malays (7.5 per cent) (ADB 2003). After being colonised by the Netherlands (350 years) and Japan (3.5 years), Indonesia declared independence on 17 August 1945. In respect to economic activities, the government is seen as a major actor in Indonesia's market-based economy. Following its independence, Indonesia experienced rapid economic growth and has been regarded as an emerging capital market. Indonesia also changed from using a Dutch to a US accounting practice.

In spite of an abundance of natural resources and growth rates of seven to eight per cent in the early 1990s, Indonesia has faced a number of economic problems, including the practice of accounting, auditing and financial disclosure (ADB 2003). Pressures for improvement of financial reporting practice grew in the wake of a series of financial reporting scandals such as Bank Duta (early 1990), Plaza Indonesia Realty (mid 1992) and *Barito Pacific Timber* (1993)¹. In addition, an empirical study showed that the level of disclosure in annual reports of Indonesian companies for the year ended 1993 was 55 per cent of international accounting standard disclosure (Craig and Diga 1998).

To avoid similar scandals and to develop a capital market for mobilising long-term investment flows, the Indonesian government and professional bodies have developed regulations governing both the capital market and accounting. As a result, in September 1994, the Accounting Standard Committee of the Indonesian Institute of Accountants (KPSAK) released a new set of accounting standard called *Pernyataan Standard Akuntansi Keuangan*

¹ For detailed discussion see ADB (2003)

(PSAK). The new standard (PSAK) replaced the 1984 Indonesian accounting standards called *Prinsip Akuntansi Indonesia 1984* (PAI 1984)². However, KPSAK adopted the international accounting standards without doing any preliminary research to determine whether the standards are compatible with the Indonesian environment and whether those standards are capable of improving the quality of financial reporting in Indonesia³. The government also issued Corporate Law No 1/1995 in March 1996 to replace corporate law codified in Indonesian Commerce Law called *Kitab Undang-Undang Hukum Dagang*, which was translated from Dutch commercial laws.

Under the new law, nonetheless, whether the quality of financial reporting in Indonesia is higher than before is still in question. In fact, a number of corporate scandals occurred not long after the release of new regulations/law. A number of instances of business misconduct, especially concerning the lack of transparency in publishing relevant and reliable information, are evidence of such scandals. This can be seen from the cases of collection of private funds to support the N-2130 jet aircraft project of IPTN⁴ (McLeod 1997), privatisation processes including private provision of public services (World Bank 1997) and the *Bapindo/Golden Key* scandal of 1994–1996⁵ (Cole and Slade 1996). The 1997 Indonesian economic crisis with the collapse of the Indonesian Rupiah was the ultimate result of a series of accounting and corporate scandals. This crisis, which made many of the country's conglomerates technically collapse (ADB 2003) and made the Indonesian government lose legitimacy with the fall of President Suharto's dynasty in 1998, further increased pressure for the government to improve the quality of financial reporting.

On August 1999 through the Decree issued by the Minister of Economics, Finance and Industry No.10/M.Ekuin/08/1999, the Indonesian government established the National Committee on Corporate Governance (NCCG), which is responsible for developing a framework of good corporate governance for the Indonesian business environment. As a result, in March 2000, The NCCG released "the Code of Good Corporate Governance/Rev. 4.0" as guidance for companies in running a transparent, responsible, accountable, and fair

² Pre-1973 financial requirements were prescribed by Dutch-based company law that required only that "adequate financial records be kept". In 1973, the Indonesian Institute of Accountants (IAI) released *Prinsip Akuntansi Indonesia* (Indonesian accounting principle)—commonly called PAI-1973 that reflected the 1965 US generally accepted accounting principles (GAAP). In 1984, IAI revised *Prinsip Akuntansi Indonesia* and issued the *1984 Prinsip Akuntansi Indonesia* (PAI-1984). In 1994, through the Seventh National Congress of IAI, Indonesia has adopted International Accounting Standards as the basis for domestic financial reporting (ADB 2003; Chariri and Ghazali 2002).

³ In an emerging capital market, financial reporting has been increasingly viewed as a vital infrastructure for the growth of capital. Although the markets are characterised by both structural problems such as small size of market capitalisation, low liquidity and limited investment choices, and political and economic problems associated with political risk and uncertainty, unfavourable government regulation and macroeconomic stability, quality financial reporting plays an important role in attracting international investors (for a detailed discussion see Saudagaran and Diga (1997). This is because the quality of financial reports enables investors to reduce potential risks caused by the political and economic problems.

⁴ IPTN is the National Aircraft Maker, a mega project, which was built by Habibie, the Minister for the Development of Technology during the era of President Suharto. In 1994 Suharto took \$190 million from a reforestation fund to support the sagging state aircraft maker. However, this project was seen as failure.

⁵ The Indonesian public witnessed that this scandal involved Sudomo, the chair of the Supreme Advisory Council and the former Minister for Politics and Internal Security Coordination during the era of President Suharto. Sudomo issued *Surat Sakti* (a special letter of reference) that allowed Edy Tanzil (a businessman) to take illegally money from Bapindo Bank.

business. This includes good corporate governance principles and guidelines concerning the role of the board of directors, audit committee, corporate secretary and corporate disclosure. The NCCG is also responsible for initiating regulatory reform. To support such reform, *Bapepam* (the capital market supervisory agency) and other authoritative bodies, such as the Indonesian Institute of Accountants, issued other regulations and accounting standards.

Even though a number of regulations have been issued to regulate financial reporting and business practice in Indonesia, they have not been able to ensure sound business practice and transparency in financial reporting. Implementation of regulations has not been smooth, and is impeded by weak law enforcement (ADB 2003). Disappointing implementation and weak enforcement might not be able to force companies to publish quality financial reports. Such weak law enforcement has led a number of companies to create and use “their own systems”, which often neglect good corporate governance principles and ethics. Consequently, within unethical and corrupt governance, it can be argued that commitment to quality financial reporting and compliance with regulations is largely determined by companies themselves within their own ethical culture.

Although a number of regulations have been released to improve financial reporting quality in Indonesia, none of studies in the Indonesian environment was directed to consider the relationship of institutions (regulations/rules) and financial reporting practice. Most accounting studies in Indonesia have been directed to investigating the relationship between economic factors, such as ownership structures, company sizes, industry types and financial performance and disclosure (for example Arifin 2002; Fitriani 2001; Marwata 2001; Susanto 1992). However, as with other empirical studies of accounting, the studies resulted in inconclusive and contradictory findings. Using Tinker’s (1991) words, accounting research in Indonesia has been “colonised by the notion of efficiency”. It is apparent that there is an institutionalised myth in the Indonesian accounting research community that accounting studies are considered to be outstanding only when they are conducted by employing “sophisticated statistical models”.

Studies of financial reporting in the Indonesian setting tend to ignore the cultural beliefs and values accepted in Indonesian society. Nevertheless, as the language of business, accounting is not value free. Hofstede’s (1982) study concluded that local culture influenced the behaviour of the Indonesians both in business and government institutions. This “local culture” refers to Javanese culture (Yudianti and Goodfellow 1997).

1.2.2 The Dominance of Javanese Culture

It has been documented that dominant culture in a society imposes pervasive influences on individual and corporate behaviour (Hofstede 1987; Kanungo and Mendonca 1996; Schein 2004). In the Indonesian business environment, it is claimed that Javanese culture is dominant in influencing the behaviour of Indonesian people (Antlov 1994; Magnis-Suseno 1997; Mann 1996; Mulder 1994; Yudianti and Goodfellow 1997).

The maintenance of social harmony is the core value of Javanese culture. To maintain social harmony, a social relationship of the Javanese is characterised by two basic principles indicating the Javanese ideas of the good life: conflict avoidance and respect (this will be further discussed in Chapter Three). The principle of conflict avoidance and principle of

respect are manifested in the Javanese social life in terms of a hierarchical position and collectivism (Chapter Three will elaborate these issues). Such manifestation can be seen in social relationships in the Indonesian environment both in business organisations and in government institutions (Hofstede 1982)⁶. Indeed, the “socio-cultural environment determines management beliefs, values and assumptions of workers and work behaviour that characterise the organisation’s work culture” (Kanungo and Mendonca 1996, p. 109).

Moreover, Javanese culture influences how individuals exercise power to lead and direct people in an organisation. The concept of a leadership style based on Javanese culture is built on a belief that a leader is a figure of *Bapak*-father and an exemplary model for their subordinates (Chapter Three will elaborate on this concept). To maintain social harmony, a leader will focus on collectivism in making a decision. In fact, as Marsh and Goodfellow (1997) emphasise, two important concepts about the leadership and decision making process in Javanese culture: *musyawarah* (mutual deliberation) and *mufakat* (the common unanimous decision) should be considered when a leader is making a decision. This is because the outcomes of decision-making are ultimately for *kepentingan bersama*-public interests/benefits (Magnis-Suseno 1997).

As culture is learned and derived by individuals from a social environment throughout their lifetime, Javanese culture is reflected in Indonesian social relationships, such as workplaces, political organisations and other institutions including financial reporting practice. March and Olsen (1989, p. 22) highlight that “behaviour is contained or dictated by cultural dicta and social norms. Actions are often based more on identifying the normatively appropriate behaviour than on calculating the return expected from alternative choices”.

Because financial reporting practice, as a part of accounting activities, is value laden (Hines 1988; Miller 1994; Morgan 1988; 1998; Munro 1998), the use of Javanese ideas of an ethical social relationship will be useful to understand how quality financial reporting has been practised in a company. Jaggi (1975) claims that the value orientation of managers greatly influences them in making financial disclosures, and that value orientation of individuals in a society to a large extent is affected by the social environment of the society.

Studies of financial reporting that consider the cultural context in the Indonesian setting include those by Sudarwan and Fogarty (1996; 1997) and Tabalujan (2001; 2002). Sudarwan and Fogarty (1996) investigated the relationship among the cultural characteristic of Indonesian society, reporting practices and accounting standards promulgated by KPSAK. It was suggested that the development of accounting standards and disclosure practices were patterned by change in cultural norms (Sudarwan and Fogarty 1996). However, as they mentioned, their study suffered from certain weaknesses such as their inability to conduct an analysis of the influence of firm’s specific culture on financial reporting practice. In addition, it is suggested that culture and accounting may be more dynamic than suspected and there may be “important qualitative aspects of the social relations” that underlie financial reporting practice that have been ignored by researchers (Sudarwan and Fogarty 1997, p. 214).

⁶ It should be noted that even though Javanese culture has an ethical view on a social relationship, this culture could be misleadingly interpreted and implemented in practice for self-interest at the cost of others. The leadership of President Suharto and his cronies in government institutions was an example of the misinterpretation of Javanese culture (See Marsh and Goodfellow 1997; Liddle 1996).

A study by Tabalujan (2001) also confirmed that culture influenced the practice of transparency in Indonesia. Tabalujan (2001) analysed practice of corporate governance (in terms of responsibility, accountability, fairness and transparency) in three Indonesian banks and concluded that such practice still diverged significantly from the stated principles of corporate governance. Such divergence, as he (2001) argues, might be due to local culture.

Elsewhere, Tabalujan (2002) analysed the impact of local culture on corporate governance practice in 259 companies listed on the Jakarta Stock Exchange in mid 1997 and 2001. He (2002) concluded that corporate governance practice was influenced by family relationship, one characteristic of Javanese values (Yudianti and Goodfellow 1997). In addition, a study by Hofstede (1982) confirmed that the four cultural dimensions (power distance, conflict avoidance, individualism/collectivism and masculinity/femininity) of Indonesian society are closely related to the characteristic of Javanese culture. This is why this study considered financial reporting practice in a company from a perspective of Javanese culture.

1.3 RESEARCH PROBLEMS

Efforts made by the Indonesian government and professional and accounting bodies have been intended to achieve a clean and fair business practice where no one gains benefit at the cost of others. However, it is recognised that despite significant improvement to the corporate governance framework during the 1990s, actual corporate governance behaviour during that decade diverged substantially from stated principles (Tabalujan 2001). A number of financial reporting problems still occur in Indonesia.

One publicly debatable case of financial reporting is the case of Lippo Bank, which published two different financial reports to the public and to *Bapepam* in 2002 (Antara 2003a; 2003b; Donnan and Hidayat 2003), although the bank had an independent board of directors and audit committee. Furthermore, during the period of 2002, there were more than 20 companies provided misleading information (*Bapepam* Annual Report 2002). *Bapepam* also reported that until the deadline of annual report submission, 31 March 2002, 87 companies (23.26 per cent of listed companies) had not submitted their annual financial statements to *Bapepam*. This figure increased to 30 per cent of listed companies (117 companies) in 2003.

On the other hand, it is recognised that some companies have published quality financial reports and awarded by *Bapepam* as the companies with the best annual reports. *PT. Asuransi Bintang, Tbk* (hereafter *Bintang*), a publicly listed insurance company, is an example of a company which publishes annual reports transparently and has been a recipient of annual report awards since the 1980s. This particular company was selected as the research setting in this study. The reason for choosing *Bintang* as a research setting is that as a publicly listed company, it has a unique culture. Furthermore, *Bintang* has been successful in implementing a corporate governance mechanism that drives its organisational members to commit to quality financial reporting practice. This can be inferred from its ability to cope with the Indonesian economic crisis while many other companies went bankrupt, and from its success in winning a number of annual report awards.

Hence, instead of studying companies with fraudulent financial reporting, which has been investigated by a number of empirical researchers, the current study focuses on a

company with the best annual reports. In other words, this study seeks to understand why, within a dirty and corrupt environment⁷, this particular company is committed to quality financial reporting practice, whereas other companies engage in unethical and fraudulent financial reporting. By understanding the financial reporting practice of *Bintang* and its organisational uniqueness, this study aims to seek answers to the following specific questions:

Why is the company committed to quality financial reporting?

How does the company construct its financial reports to deliver a message to its audience?

To what extent do external institutional pressures, such as regulations/rules, force the company to provide information in financial reports?

In what ways do intra-organisational dynamics, such as beliefs, values, norms, power and leadership, influence financial reporting practice?

1.4 RESEARCH OBJECTIVES

Understanding the dynamics of financial reporting practice is not easy. The starting point for this study is the belief that financial reporting practice is an institutional and political practice. As a part of accounting systems, it is a socially constructed reality. From this view, financial reporting practice can only be developed by reference to the particular setting in which it is embedded (Burchell, et al. 1980; Hopwood 1983; Miller 1994). Thus, following Nahapiet (1988), this research was guided by a desire to develop an understanding of the way people communicate, behave and act in their everyday life and how this affects and is affected by financial reporting practice. This means that the study does not set out to test a set of specific hypotheses, but to observe and describe the actions and views of organisational members of *Bintang* and to identify the meanings underlying such actions (Burchell et al. 1980; Harre and Secord 1972; Nahapiet 1988). Following a view expressed by Hopwood (1983), such a study must be directed at financial reporting practice in an organisational setting.

This study is therefore not directed to generalise the dynamics of financial reporting practice in Indonesia. Instead, it is intended to understand in depth the dynamics of financial reporting practice in *Bintang* from the perspective of institutions, power and organisational culture within the framework of Javanese culture at large. In particular, this study intends to understand:

1. The reasons of and processes by which *Bintang* construct financial reporting
2. The organisational and institutional factors that influence financial reporting practice of *Bintang*
3. The extent to which there is institutionalisation of values, beliefs, and norms in *Bintang*
4. The exercise of power by the actors involved in the corporate governance mechanism in shaping financial reporting practice of *Bintang*.

⁷ See International Corruption Watch, which ranked Indonesia as one of the most corrupt countries.

1.5 SIGNIFICANCE OF STUDY

This study can be seen as a first attempt to understand and financial reporting practice from an institutional and power perspective within a framework of the dominant culture in Indonesia—Javanese culture. Consequently, the significance of the present study comes from two sources. First, the concepts developed here are relatively new to financial reporting studies. As such, the study represents a first effort to familiarise accountants with organisational uniqueness, power politics and a unique culture in financial reporting practice. This study can enhance sociological studies on accounting and develop the understanding of accounting knowledge and practice within social, political, institutional and cultural contexts. For the purpose of this theoretical exercise, the results of the literature review bring together a diversity of research efforts in financial reporting and provide a contribution to other studies in several disciplines.

Second, findings of the study could help industry groups, insurance regulators (the Directorate General of Financial Institutions), accounting standard setters (*Bapepam* and the Indonesian Institute of Accountants), and others to better determine the reporting requirements of insurance companies, and assist them to develop more effective regulatory initiatives such as regulations on disclosure and type of enforcement.

1.6 STRUCTURE OF ANALYSIS

In order to explore and explain the dynamics of financial reporting practice, it is desirable to have a coherent structure of analysis. This study is developed in eight main sections. At the outset, the second chapter will critically review current studies on financial reporting. Such a review is not a new idea, but by critically evaluating the existing studies of financial reporting, it will be clear why this study adopts an approach different from positive accounting research.

Next, the third chapter will discuss the theoretical background underlying this study. The use of institutional theory and power mobilisation by Hardy (1996) is perceived useful as a lens of understanding financial reporting practice, because ontologically, this study claims that financial reporting practice is a socially constructed reality providing the supply of information. Furthermore, this chapter will describe Javanese views on an ethical social relationship.

Chapter Four describes the integrated theoretical framework and the research approach employed in this study. Chapter Five portrays the historical background of *Bintang* used as the research setting. The following three chapters analyse why and how the company is committed to a quality financial reporting practice.

Chapter Six is directed towards a description and analysis of why *Bintang* commits to quality financial reporting practice, and how the company constructs its annual reports to gain legitimacy and maintain social harmony.

Chapter Seven describes and analyses how institutional pressure and cultural environment influence financial reporting practice and how the actors of *Bintang* construct organisational structures and culture and institutionalise beliefs, values and norms to respond to the pressure and environment. The Javanese ideas on social relationships are used in this

Financial reporting practice has been seen as one that concerns technical and economic aspects. However, it is argued that financial reporting practice is a socially constructed reality. This book provides evidence of such claim based on an ethnographic case study conducted in an Indonesian insurance company.

This study reveals that the company is committed to quality financial reporting because such reporting can be used to gain legitimacy and to maintain social harmony. The way the actors in the company construct such practice is influenced by its organisational culture, which reflects Javanese culture. In addition, the exercise of power and leadership in the company determines the construction of such practice. The Javanese philosophy of power and leadership has shaped such exercise of power and leadership. Leaders of the company have been able to show themselves as exemplary models for their subordinates (*ing ngarso sung tulodo*), as individuals who are able to empower subordinates (*ing madyo mangun karso*), and have a sense of responsibility to their subordinates (*tut wuri handayani*). Thus, such practice reflects the Javanese ideas on an ethical social relationship.



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