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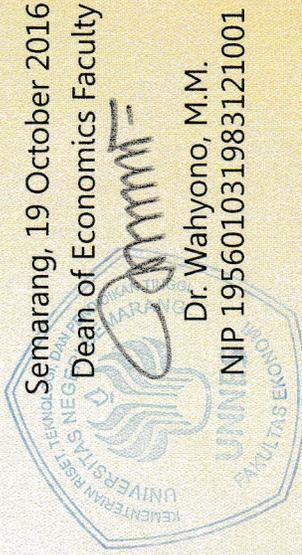
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CORPORATE GOVERNANCE AND FINANCIAL STATEMENT FRAUDS: EVIDENCE FROM INDONESIA

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Abstract: This study aims to investigate the effect of corporate governance on financial statement frauds. The variables of the corporate governance consists of independent Board of Commissioners (IND), managerial ownership (OSHIP), audit committee meeting (MEET) and quality of external auditor (AUD). Agency theory was employed to explain how such variables may influence financial statement frauds. Population of this study was companies listed in the Indonesia Stock Exchanges (IDX) which were suspected for being involved in financial statement frauds from 2008 to 2012. Total sample were 38 companies, consisting of 19 companies which were penalised by the IDX regulator because of their potential fraudulent financial statement, and 19 companies that are not financial statements fraudsters from the same industry (sectors). Data were then analysed using logistic regression method. The findings of this study indicated that audit committee meeting (MEET) significantly influenced financial statement frauds. Meanwhile, independent Board of Commissioners (IND), managerial ownership (OSHIP) and interaction of quality of external auditor (AUD) and audit committee meeting (MEET) have no significant impact on financial statement frauds.

Keywords: financial statement frauds, corporate governance, agency theory, indonesia stock exchanges.

INTRODUCTION

Financial statement frauds have been seen as interesting phenomena that have attracted accounting scholars to investigate. Indeed, a number of companies were committed to frauds by manipulating financial statements to mislead stakeholders. Fraudulent financial statements have been associated with corporate governance. According to Dechow (cited by Skousen et al., 2009) the highest incidence of frauds in companies is related to weak corporate governance. A number of frauds occurred at the company with board dominated by insider parties and likely did not have an audit committee (Dechow et al. in Skousen et al., 2009).

Frauds can take place in companies where there is a separation between the ownership of the company and its management (Meutia, 2004). Good corporate governance is required to reduce the agency problem between owners and managers (Ritonga, 2014).

Studies regarding corporate governance and fraudulent financial statements have been conducted in a numbers of countries especially in developed countries but the studies have resulted in inconsistent findings (see Chen et al., 2006; Beasley, 1996; Jackson, 2009). As the fact that such studies have been done in different countries with different environment, it is necessary to investigate the similar issues in Indonesia. This study aimed to analyze the influence of corporate governance: the proportion of independent board, managerial ownership, the number of audit committee meetings and the quality of the external auditor on fraudulent financial statements.

Studying corporate governance and fraudulent financial statement cannot be separated from agency theory e. Messier et al. (2006) claim that agency relationship raises two issues: (1)

The occurrence of asymmetric information, ie management generally has more information than the owner, (2) The occurrence of a conflict of interest due to the inequality of the goal, where management does not always act in the interests of the owners.

Asymmetric information may mislead the users of financial statements in the decision making process. The increasing asymmetry of information between the manager (agent) with the owner (principal), push the adverse action such as fraud or earning manipulation in financial reporting. Such actions are a result of the conflict of interest and asymmetric information with the owner. Rezaee (2002) stated that actual earnings management is closely related to financial statement fraud. Based on these descriptions, it can be concluded that the agency problem between owners (principal) and management (agent) can trigger a financial statement fraud that may mislead stakeholders.

Independent Board of Commissioner and Fraudulent Financial Statement.

Information asymmetry between managers and owners could lead to fraud. To prevent potential frauds in the company, a company needs an oversight body to play roles in monitoring manager behaviour. Thus, in any companies, it is necessary to have independent board of commissioners to prevent frauds. The independent board of commissioners have trustworthy and is responsible for overseeing the daily business operations, including policies made by management (Chen et al., 2006). The presence of independent board is expected to minimize fraudulent financial statements. Members of commissioners coming from the outside companies is believed to conduct more independent oversight than insiders. This encourages a more effective supervision of the company so that the opportunity to commit fraud can be reduced. Research by Dechow et al. (1996) showed that frauds are more common in companies that have fewer independent boards of commissioners (Skousen et. al., 2009).

H1: The proportion of independent board of commissioner negatively influences on fraudulent financial statements

Managerial Ownership and Fraudulent Financial Statement

Managerial ownership shows the proporsion of shares owned by insiders. Ownership of shares by insiders can considered as a policy to solve agency problems, as managerial ownership will align the interests of management to the interests of shareholders as w whole. Management policies expressed in in term of company's financial performance can be affected by the number of shares possessed by the insiders. Consequently, manager will make any decisions that increase firm values and will be more tranparent in presenting financial information. In other words, managers will works on the best interest of principals. Study by Chen et al. (2006) indicated that the higher the percentage of managerial ownership, then the the lower the fraudulent financial statement.

H2: Managerial ownership negatively affects fraudulent financial statements

Audit Committe Meeting and Fraudulent Financial Statement

The audit committee plays important role in assisting the board of commissioners especially in supervisory duties of financial reporting. The committe helps prevent agency problems as a result of differences in interests between the principal and agent. The audit committee may show their role in supervising financial reporting through regular meetings. The more intenstive meeting will enable the committee to minimize the opportunity for managers to manipulate financial reporting. Beasley et al. (1996) found that audit committees of companies committed to fraud has less meeting (once a year). Abbott et al. (2000) claimed that the audit committee meeting arranged at least twice a year would be associated with a decrease in the

possibility of frauds. Consequently, the more the meeting of audit committee the lesser the possibility of financial statement frauds (Jackson, 2009).

H3: The number of audit committee meetings have negative influence on fraudulent financial statements

Interaction of External Auditor Quality and Audit Committee Meeting

An external Auditor is part of corporate governance that plays important roles in controlling the behavior of management. External auditors may interact with committee audit to supervise financial reporting. Such interaction may prevent and detect the possibility of frauds, especially financial statement frauds (Chen et al, 2006). The involvement of external auditors may help the effectiveness of audit committee meetings in minimizing fraud. The quality of the external auditor in detecting frauds can help the audit committee to follow up any audit findings so as to prevent or detect fraud occurring. Thus, the interaction of external auditor and the audit committee can reduce the level of fraud. The external auditors may strengthen the effect of audit committee meetings on fraudulent financial statement.

H4: Interaction of external auditor quality and the number of audit committee meetings has negative influence on fraudulent financial statements.

METHODS

Fraudulent financial statements were measured by dummy variables categorized into two: code 1 (one) for firms fraud based on reports from the Financial Services Authority (OJK) describing the companies that were considered as fraudulent because they broke regulation of Bapepam (now Financial Service Authority /OJK) Number VIII.G.7 about presentation and disclosure of financial statements of listed companies and otherwise code 0 (zero). The proportion of independent commissioners (IND) was measured using a total independent commissioners divided by total commissioners. Measurement of managerial ownership (OSHIP) is based on total insider ownership divided by total outstanding shares. Number of audit committee meetings were measured by the total number of audit committee meetings (MEET). Finally, the quality external auditors (AUD) is proxied by dummy variables, the value of 1 if the company is audited by a large accounting firm (PwC, KPMG, Deloitte and EY), and 0 if other.

Companies listed on the Indonesian Stock Exchange (BEI) 2008 – 2012 were used as population. Sample was determined based on purposive sampling method with the following criteria:

1. Non financial sector companies having required data on annual reports from 2008 to 2012,
2. Companies categorized by OJK violated the rules Number VIII.G.,
3. Companies classified as a non fraud were used as pairs and taken from the same industries having assets approaching or almost the same as the fraudulent companies

Data were analysed using logistic regression with the following equation:

$$\ln (p / 1 - p) = \alpha - \beta_1 \text{IND}_t - \beta_2 \text{OSHIP}_t - \beta_3 \text{MEET}_t - \beta_4 \text{AUD}_t - \beta_5 \text{AUD}_t * \text{MEET}_t + e$$

$\ln (p / 1 - p)$ = Companies with Fraudulent Financial Statement (1) and 0 (zero) for others

IND_t = proportion of independent board of commissioners

OSHIP_t = proportion of managerial ownership

MEET_t = the number of audit committee meetings

AUD_t = dummy variables, code 1 (one) for Big Four Audit Firms, code 0 (zero) for the other

RESULT AND DISCUSSION

Based on the report from OJK (Financial Services Authority) 2008-2012, a sample of 19 companies committed to frauds and 19 non-fraud companies can be seen in Table 1.

Table 1
Fraud and Non-Fraud Companies

Industry	Fraud	Non Fraud	Percentage
Agriculture	-	-	-
Mining	5	5	26,32%
Basic Industry and Chemicals	5	5	26,32%
Miscellaneous Industry	1	1	5,26%
Consumer Goods Industry	-	-	-
Property, Real Estate and Building			
Construction	3	3	15,79%
Infrastructure, Utilities and Transport	1	1	5,26%
Trade, Services and Investment	4	4	21,05%
Total	19	19	100%

The companies were then classified into the number of companies based on the years of fraud occurrence as reported in Table 2.

Table 2
Fraud and Non Fraud Companies by Years

Years	Fraud	Non Frauds
2008	3	3
2009	4	4
2010	7	7
2011	2	2
2012	3	3
Total	19	19

Based on Table 2, it can be seen that the companies committed to fraudulent financial statement tended to increase from 2008 to 2010 and decrease in 2011, then decreased in 2012. Details variables can be seen on Table 3

Table 3
Descriptive Statistics

Variable	Fraud		Non Fraud	
	Mean	St. Deviation	Mean	St. Deviation
Independent Commissioner	0.3800	0.0873	0.3747	0.0826
Managerial Ownership	0.1034	0.2703	0.0036	0.0100
Audit Committee Meeting	5.16	3.404	10.89	9.944

Table 3 reported that fraud companies, on average, had proportion of independent commissioners of 38.00%, while non-fraud companies had 37.47%. Fraud companies had greater managerial ownership, around 10.34%, compared to 3.6% non-fraud companies. Finally, on average, fraud companies held around 5 meeting during a year whereas non-fraud companies had higher audit committee meeting (around 11 times a year)

Table 4
External Auditor Quality: Fraud and Non Fraud

		Company		Total	
		Non fraud	Fraud		
AUD	Non Big 4	Count	12	17	29
		% within FRAUD	63.2%	89.5%	76.3%
	Big 4	Count	7	2	9
		% within FRAUD	36.8%	10.5%	23.7%
Total		Count	19	19	38
		% within FRAUD	100.0%	100.0%	100.0%

Table 4 showed that nine companies or only 23.7 % of the total sample were audited by the Big 4 and the others (76.23%) were audited by Non-Big 4. Fraud Companies (10.5 %) are audited by a Big 4 accounting firm, while non-fraud companies (36.8 %) were audited by Big 4.

Based on goodness of fit test, it can be seen that the significant value of Hosmer and Lemeshow was 0.563. As the value is greater than the significant level $\alpha = 5\%$, thus, this value implied that the logistic regression model can be used to analyze the predictive model of the companies which commit to fraudulent financial statements. The results of hypothesis test can be seen in Table 5.

Table 5
Hypothesis Test

Variable	Significant Value ($\alpha = 5\%$)
Independent Board of Commissioner	0.581
Managerial Ownership	0.233
Audit Committee Meeting	0.019*
Quality of External Auditor	0.511
Interaction of Quality of External Auditor and Audit Committee Meeting	0.375

Note: Significant at 5%

The result of the first hypothesis test showed that independent board of commissioner didnot significantly affect financial statement fraud with a significance value of 0.581. This implies that the number of independent commissioner do not effectively reduce fraudulent financial statements of companies listed on the Indonesia Stock Exchange (IDX). The establishment of independent commissioner in the companies is only done to meet the regulations of Good Corporate Governance. Indeed, it is compulsory for companies listed in the IDX to have independent commissioners at least 30 % (thirty percent) of all commissioners . The results of this study are supported by study by Zulfiqar et al. (2009) which states that independent boards do not adversely affect fraud management measures (earnings management).

The second hypothesis test also indicated that managerial ownership didnot negatively affect the financial statement fraud with a significance value of 0.233. The more shares owned

by the insiders cannot prevent the likelihood of fraudulent financial statements. This finding did not support agency theory claims that insider ownership can be used as media to supervise manager behavior. Sukartha (2007) claims that the greater managerial ownership, the more likely the managers to fulfill the interest of principals including intention to commit frauds. In fact, executives who have personal financial interest can threaten the company financial performance (Beasley, 1996).

The third hypothesis test of the relationship of audit committee meeting and fraudulent financial statement was supported. This finding implied that the number of audit committee meetings negatively affect fraudulent financial statement (significant value of 0.019). Indeed, the increasing surveillance and control through audit committee meeting reduce conflict of interest between principal and agent. Routine audit committee meetings enable the members of audit committee to continuously oversee financial reporting process. The interactive communication established at the meeting enables audit committee, external auditors, managers and internal auditors, to minimize the possibility of frauds. The results of this study support findings of Owens et al. (2009) that the frequency of audit committee meetings have negatively affect the possibility of fraudulent financial reporting.

The fourth hypothesis test on the role of external auditor quality in moderating the relationship of audit committee meeting and financial statement frauds was not supported. This indicated that the quality of interaction of external auditors and the number of audit committee meetings did not affect the financial statement fraud (significant value of 0.375). Communication established at a meeting of the audit committee with external auditors or managers or internal auditors does not play roles in reducing the level of fraud early. This may happen as the fact that auditors deter fraud in the company by means of detection of potential fraud and then suggest a revision or restatement of financial statements (Chen et al., 2006). If the external auditors find something that is not in accordance with generally acceptable accounting standards and is related to frauds, but the company does not want to follow the suggestions for improving the presentation of financial statements because of different interests, the financial statement fraud may still occur. This finding was consistent with claims by Becker et al. (1998) that the demands of reducing fraud management can not be influenced by the public accounting firm and audit committee meetings.

CONCLUSION

The findings of this study claims that several factors of corporate governance may influence financial statement fraud. Of the four factors studied (the proportion of independent board, managerial ownership, audit committee meetings and interaction of the external auditors quality and audit committee meeting), only number of audit committee meetings positively influenced financial statement fraud. This implies that the more audit committee meetings held, the more effective supervision so as to minimize the potential financial statement fraud. While other variables, the proportion of independent board, managerial ownership and interaction of external auditor quality and audit committee meeting did not affect fraudulent financial statement.

Limitation of this study is related to the availability of sample (small sample size) as the fact that data of company committed to financial statement frauds were only 19. Data of such companies can only be obtained from a report by the Financial Services Authority (OJK). To increase data, future research may consider the use of Beneish Ratio as measurement to determine companies which are potentially committed to frauds. The future research may also include other factors such as firm characteristics (financial distress, leverage, profitability and other ownership types) as determinants of financial statement frauds

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