THE IMPACT OF AUDIT COMMITTEE EFFECTIVENESS ON TIMELINESS OF REPORTING: INDONESIAN EVIDENCE

BY

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A dissertation submitted in fulfilment of the requirement for the degree of Master of Science (Accounting)

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ABSTRACT

The objective of this study is to examine the effect of audit committee effectiveness on timeliness of reporting. Specifically, the study investigates whether there is any association between effectiveness of an audit committee and submission of audited financial statements to Indonesia Stock Exchange. Audit committee effectiveness is measured by an index based on the framework developed by DeZoort et al. (2002). The index includes 10 requirements related to aspects of structure, membership, independence, job duties, and disclosure of audit committee in company annual reports. The sample comprises 76 late-filing and a matched pair of 76 timely-filing listed companies in 2008. Logistic regressions analysis indicates that timeliness of reporting is associated with listed companies' audit committee effectiveness and audit completion time. Further analysis also indicates that among the aspects in the audit committee effectiveness index, audit committee meetings and the presence of a clear mandate (detail explanation) defining the responsibilities of audit committee in the audit committee report decrease the likelihood of late-filing behavior.

خلاصة البحث

والهدف من هذه الدراسة هو فحص تأثير فعالية لجنة المراجعة في وقت تقديم التقارير. خصوصا الدراسة بفحص ما إذا كان هناك أي ارتباط بين فعالية لجنة المراجعة وتقديم البيانات المالية المدققة لاندونيسيا للأوراق المالية. تقاس فعالية التدقيق من قبل اللجنة فهرس استنادا إلى الإطار الذي وضعته **DeZoort**. (2002). الفهرس يتضمن 10 الاحتياجات المتعلقة بالهيكل والعضوية والاستقلال ، والوظيفة، والكشف عن لجنة المراجعة في التقارير السنوية للشركات. عينة تضم 76 في وقت متأخر من ايداع وزوج متطابق من الشركات في الوقت المناسب للايداع 76 المدرجة في 2008. السوقي انحدارات يشير التحليل الذي يرتبط توقيت تقديم التقارير مع الشركات المدرجة مراجعة فعالية اللجنة ومراجعة الحسابات وقت الإنجاز. مزيد من التحليل يشير أيضا إلى أن من بين الجوانب في فعالية مؤشر لجنة المراجعة، واجتماعات لجنة المراجعة وجود تفويض واضح (شرح بالتفصيل) تحديد مسؤوليات لجنة المراجعة في تقرير لجنة المراجعة تقليل احتمالات السلوك في وقت متأخر من الايداع.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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Nazli Anum Mohd Ghazali
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Siti Rochmah Ika

Signature …………………………………… Date ………………………...

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Affirmed by Siti Rochmah Ika

……………………… Signature

……. ……………….. Date

I wish to dedicate this thesis to my parents, both my own and in-laws who prayed for my excellence and taught me never to give up. I also dedicate this thesis to my beloved husband, Ari, my children, Aza and Pasha. I dedicate this thesis to my country, Indonesia, which has provided an appropriate circumstance to conduct a good research.

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LIST OF ABBREVIATIONS

AAA	: American Accounting Association
AC	: audit committee
ACE	: audit committee effectiveness
ACGA	: Asia Corporate Governance Association
AGM	: annual general meeting
APB	: Accounting Principles Board
BAPEPAM	: Capital Market Supervisory Agency
BOC	: board of commissioners
BOD	: board of directors
BRC	: Blue Ribbon Committee
CEO	: chief executive officer
CFA	: certified financial analyst
CFR	: changes in financial risk
CLSA	: Credit Lyonnais Securities Asia
CNR	: change in net return with respect to previous year
CPA	: certified public accountant
CR	: current ratio, current assets to current liabilities
FASB	: Financial Accounting Standard Board
FCGI	: Forum for Corporate Governance in Indonesia
FR	: financial risk or total debt to equity ratio,
GCG	: good corporate governance
IBRA	: Indonesian Banks Restructure Agency
ICMD	: Indonesian Capital Market Directory
IDX	: Indonesia Stock Exchange
IICG	: the Indonesian Institute of Corporate Governance
IKAI	: the Association of Audit Committee in Indonesia
IMF	: International Monetary Fund
JSX	: Jakarta Stock Exchange
LEV	: leverage, total debt to total assets
MIA	: the Malaysian Institute of Accountant
MICPA	: the Malaysian Institute of Certified Public Accountant
MIM	: the Malaysian Institute of Management
MNCs	: multinational corporations
NACRA	: National Annual Corporate Report Award
NCCG	: the National Committee for Corporate Governance
NYSE	: New York Stock Exchange
OECD	: Organization for Economic Cooperation and Development
ROA	: return on asset, ratio of net income to total assets
ROE	: return on equity, ratio of net income to total equity
SEC	: the Securities Exchange Commission
SFAC	: Statement of Financial Accounting Concepts
SFAS	: Statements of Financial Accounting Standard
SOEs	: state owned enterprises

SOX	: Sarbanes-Oxley Act
SSE	: Sydney Stock Exchange
TR	: transaction ratio, ratio of annual trade value to number of issued stock
US	: United States

LIST OF STATUTES

Company Law (Law No. 40/2007 amendment of Law No. 1/1995) (Indonesia)
Income Tax Law (Law No. 17/2000 amendment of Law No.7/1983) (Indonesia)
Capital Market Law (Law No. 8/1995) (Indonesia)

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

In this chapter the researcher presents the introductory part of the study. The description of background of the study is presented in the following section. Subsequently, the researcher discusses the motivation for the study. This is followed by research objectives as well as the significance of the study. This chapter ends with the organisation of the thesis.

1.2 BACKGROUND OF THE STUDY

Timely release of corporate financial report, that is the availability of the information before it loses its capacity to influence the decision makers, has long been recognized as one of the qualitative attributes of financial reporting (e.g., the American Accounting Association, 1955; the Accounting Principle Board, 1970; and Financial Accounting Standard Board, 1980). In the context of financial statement issuance, this attribute suggests that financial statements shall be made available to the public within a reasonable period of time from the close of a company's financial year-end, otherwise the usefulness of the statements would be impaired (the Indonesian Statements of Financial Accounting Standard Number 1, 1998). In the capital market where corporate financial information is a primary source of information to shareholders, timely publication of the information is crucial. For investors, timely reporting reduces the uncertainty related to investment decision (Ashton, Graul, and Newton, 1989). It also reduces asymmetric dissemination of financial information among stakeholders in the capital market (Jaggi and Tsui, 1999). Therefore the occurrence of leak, rumours and insider trading in capital market can be alleviated (Owusu-Ansah, 2000).

In order to protect shareholder's interests in the capital market, the regulatory authorities worldwide have issued several rules concerning the timeframe for information submission. The rules are intended to ensure that shareholders are given the basic right to obtain relevant information from the corporations on timely and regular basis. In the United States (US) for example, after the collapse of Enron, the Securities Exchange Commission (SEC) has shortened the regulatory filing deadline of Form 10-K[1] from 90 days to 75 days, and then to 60 days starting in 2003.

In Indonesia, the issue of timeliness of reporting has received increased attention especially after the 1997 monetary crisis. In corporate governance context, the prompt release of company's financial information is important as it relates to corporate transparency (the Indonesian Code of Corporate Governance, 2001). Badan Pengawas Pasar Modal or Capital Market Supervisory Agency (hereafter BAPEPAM) and Indonesia Stock Exchange (hereafter IDX) as the capital market authorities have issued and amended several rules concerning the timeframe submission of listed company's financial report. As stipulated in the BAPEPAM Decree No. 36/PM/2003 (BAPEPAM Rule Number X.E.1) concerning Obligation to Submit Periodical Reports, and the Decision of Jakarta Stock Exchange's[2] (JSX's) Directors No. Kep-306/BEJ/07-2004 (IDX Rule Number I-E) concerning the Obligation of Information Submission, listed companies are required to submit the

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[1] 10-K form refers to the audited financial statements together with auditor report and management report in the non-US stock exchange.

[2] Jakarta Stock Exchange is the former name of Indonesia Stock Exchange. Since December 01, 2007, Jakarta Stock Exchange merged with Surabaya Stock Exchange, another exchange in Indonesia, and became Indonesia Stock Exchange.

audited annual financial statement to BAPEPAM and IDX at the latest at the end of the 3rd (third) month after the date of the annual financial statement. The three months regulatory deadline in these regulations is shorter as compared to previous regulation that requires 4 (four) months as the due date (i.e Chairman BAPEPAM's Decree Number Kep-38/PM/1996). According to Leventis, Weetman, and Caramanis (2005) minimising the gap between the end of the financial year and the publication of the audited financial statements would enhance market efficiency.

There is also the imposition of sanction for the late submission of financial statements. Types of the sanctions vary from written warning, fines, and temporary suspension of trading of listed company's stock at IDX. Despite the enforcement, the incidence of late filing in IDX seems to occur quite frequently. According to IDX announcement, there has been an increasing trend of late filing cases for the past years since 2006. It was 13.7% and 14.5% in 2006 and 2007 respectively. Then, the case of late filings increased significantly to 20% in 2008. The undue delay in releasing financial information would increase market inefficiency (Ismail and Chandler, 2003) and may result in the decreased of investor confidence in the capital market (Leventis et al., 2005). Based on the above discussion, it would appear relevant to study the factors influencing untimely reporting behaviour in the Indonesian environment.

1.3 MOTIVATION

Prior studies have examined the association between audit committee (hereafter AC) and financial reporting quality using a number of proxies for financial reporting quality. These proxies include fraudulent financial reporting (e.g. Abbot, Park, and Parker, 2000; Beasley, Carcello, Hermanson, and Lapides, 2000), financial reporting restatement (e.g. Abbot, Parker, and Peters, 2004; Lin, Li, and Yang, 2006), earnings management (e.g. Xie, Davidson, and DaDalt, 2003; Bedard Chtourou, and Courteu, 2004; Yang and Krishnan, 2005), level of interim financial disclosure (Mangena and Pike, 2005), qualified audit report (e.g. Pucheta-Martinez and Fuentes, 2007) and timeliness of reporting (e.g. Asri, 2005; Abdullah, 2006; Afify, 2009).

Prior studies that examine the relationship between AC and timeliness of reporting, only look at individual characteristics of AC such as the presence or absence of AC in the sample company (Afify, 2009), the number of independent member of AC (Abdullah, 2006), and the number of financial expertise in AC (Asri, 2005). Among those studies, only AC formation was significant in explaining timeliness of reporting. However, in a country where AC formation is mandatory for listed companies, AC formation alone would not give impact to the effectiveness of AC. Likewise, the examination of individual characteristic of AC may not be adequate to assess the relationship between AC effectiveness and timeliness of reporting. Therefore this study attempts to develop AC effectiveness index to assess the effectiveness of AC in influencing timeliness of reporting.

The purpose of this study is to examine whether AC effectiveness has association with financial statements filing behaviour. The primary role of AC is to help ensure “high quality of financial reporting” (Bedard et al., 2004: 6). The quality assessment of financial reporting should include timeliness of reporting, because information cannot be relevant if it is not supplied in a timely manner (the Statement of Financial Accounting Concepts, 1980). Therefore, this study attempts to investigate the relationship between AC and financial reporting quality, that is, whether timely-filing firms have better AC monitoring mechanism compared to late-filing firms.

The current study fills the gap in the literature by utilizing a subset of criteria of AC effectiveness to develop AC effectiveness index. The development of AC effectiveness index is based on DeZoort, Hermanson, Archambeault, and Reed's (2002) AC effectiveness framework. The index comprises of requirements related to aspects of structure, membership, independence, job duties, and disclosure of audit committee in company annual reports.

Additionally, there has been little research on determinants of late filing behaviour. The popular research in timeliness of reporting uses time lag (i.e. the number of days from financial year-end to the release of financial report) to measure timely reporting behavior rather than a dummy variable indicating a company was late or on time in releasing financial information as according to the regulation. Moreover, prior studies in determinant of late filings (i.e. Alford et al., 1994; Bryant-Kutcher et al., 2007; Dalton, et al., 2010) were carried out in the United States (US). Thus, this study attempts to add to the existing body of knowledge by examining factors that may be associated with late filing in an emerging country, specifically Indonesia. There has been critique that corporate governance system in the country is good in form, but not in the implementation (Rosser, 2003; Daniel, 2003). The examination of AC which is part of corporate governance mechanisms as one of the determinant factors of timeliness of reporting may provide insight on the role of AC in a developing country whether ACs enhance financial reporting quality or for window dressing purposes only.

1.4 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS

The main objective of this study is to examine whether AC effectiveness has association with financial statements filing behavior. AC effectiveness is measured by a subset of criteria of AC effectiveness (an index) based on DeZoort et al.'s (2002) AC effectiveness framework. According to DeZoort et al., (2002) there are 4 (four) dimensions that determine AC effectiveness: (1) composition, (2) authority, (3) resources, and (4) diligence. Therefore the second objective of this study is to examine which dimensions of the AC effectiveness index have association with financial statements filing behavior. Consistent with prior studies (e.g. Bryant-Kutcher et al., 2007; Dalton et al., 2010), this study also investigates other variables that may influence late filing (or timeliness of reporting) such as financial condition, size, audit completion time, and type of industry.

To meet the objectives of the study, two types of research questions have been developed i.e. general research question and specific research questions. These research questions attempt to investigate the determinant factor of timely reporting behavior where timeliness is measured by whether a company was timely or late in filing its financial accounts to the stock exchange. The research questions (RQs) are as follows:

RESEARCH QUESTIONS

RQ 1: Does AC effectiveness affect timeliness of reporting?

RQ 2: Which dimension of the AC effectiveness index affect timeliness of reporting?

RQ 3: What are other factors affecting timeliness of reporting?

More specifically this research attempts to answer the following question.

RQ i: Is there any difference between timely and late-filing firms in terms of AC effectiveness, the dimensions in the AC effectiveness index, and other factors such as financial condition, size, audit completion time, and type of industry?

1.5 CONTRIBUTION OF THE STUDY

This study is significant as it has several implications for research. First, this study provides empirical evidence on the role of AC as one of the corporate governance mechanism, in ensuring financial reporting quality in an emerging country. The research finds evidence that the effectiveness of AC may reduce the likelihood of untimely behavior related to the submission of financial information to the stock exchange. Despite the critique that corporate governance mechanism in Indonesia is good in book but not in implementation (Rosser, 2003; Daniel, 2003), the finding in the present study suggests that in a country, the existence of AC may be effective in enhancing financial reporting quality in terms of timeliness.

Second, this study also provides evidence that in terms of AC effectiveness, AC meetings and AC defining clear mandate (explaining responsibilities) have significant association with late-filing behavior. This findings suggest that ACs which have sufficient number of meetings held during each financial year (at least four meetings in a year) and with a greater commitment to AC responsibility disclosure in annual report are likely to be more effective which in turn reduce the likelihood of untimely reporting behavior.

1.6 ORGANIZATION OF THE DISSERTATION

This thesis will be organized into seven chapters, including this chapter, which presents the introductory chapter of the thesis. Chapter 1 provides a brief explanation of the background, motivation and objectives, as well as a brief description of the contribution of the study. The chapter ends with a short description of the organization of the study.