CORPORATE GOVERNANCE, AUDIT FIRM SIZE AND RESTATED FINANCIAL STATEMENT IN INDONESIA STOCK EXCHANGE

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Abstract

This research aims to describe the corporations to take restatement in financial statement such as, corporate governance implementation and size of Audit Firm. Corporate Governance and size of Audit Firm are involved in auditing process. Theoretically, those influence the quality of financial statement. The occurrence of restatement of financial reporting is as a proxy for a lower of financial statement quality. Hence, corporate governance and size of Audit Firm should prevent from restated financial statement. The result of this research describe that number of independent commissioner and number of audit committee do not prevent from restated financial statement. In addition, size of Audit Firm is not obvious to increase the quality of financial statement, because there are several of big four audit firms have been appointed by such corporation as external auditor or some of restatements have been done by non-big four. This research describes the composition of independent commissioner, audit committee and also Audit Firms size do not influence directly to restated financial statement.

Keywords: Restated Financial Statement; Corporate Governance; Size of Audit Firm

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I. Introduction

This research observes disclosures surrounding restatements filed and some wording of audit opinion from 2003 to 2009 to describe the evidence of explanations from underlying cause of restatements. Relying on these disclosures, we classify each restatement as having been attributed to one of the following four causes: (1) an internal company error, (2) intentional manipulation, (3) transaction complexity, and (4) some characteristic of the accounting standards (Plumlee and Yohn, 2009). From that observation, restated financial statement come from internal process (corporation) and external process (Audit Firm) in financial statement. This means that corporation has a corporate governance mechanism to implement the whole of the corporate governance concept, such as independent commissioners and audit committee. They exist because corporation needs them to involve in financial reporting (financial statement) preparation. They intervene in audit firm selection as external auditor and reviewing the internal control process to make sure that the financial data is right.

In capital market, it is important that the corporations follow regulation to present financial statement fairly. Beside, they must be audited by Audit Firm. But occurrence of restated financial statement indicates that there is something wrong in internal process or external process from financial statement preparation. Corporations have obligation to present the audited financial statements for corporate listed on the Indonesia Stock Exchange. Those events are related to restated financial statement that are presented to market or investors. The complexity in measurement and recognition of the transactions can lead to the restated financial statement. This situation causes the violation in preparing the financial statements.

Accounting complexity is a primary driver of restatements (Ciesielski and Weirich, 2006), which is a trigger for corporations to restate the financial statement. The restated financial statement leads to high transaction costs due to error in the first presentation. This error causes in misleading to interpret the condition of the corporation and finally influences decision making in stock market. This would also be inefficient in capital allocation and also The condition is not good for the capital market, mostly for investor.

The occurrence of restatement could be avoided by corporate governance implementation. Hence, it is necessary for corporation to implement the concept of corporate governance (CG). This is part from corporate reformation how corporate govern well. They can reduce the agency cost resulting from the role of agents who try to fulfill their self-interest and also by involving outside parties of the corporation to monitor how they perform good corporate governance.

The process of preparing the financial statements must involve the external parties as a Independent Auditor (Audit Firm) to conduct audit process. That involvement is to ensure that the financial statements have been presented fairly and truthfully according to accounting regulation. Additionally, the implementation of corporate governance mechanisms is a characteristic of the corporation, as a manifestation of their concern towards the highly quality of financial statements. It means to reduce the gap of knowledge between users and preparers which is called information asymmetry. Audit firm (Independent Auditor) has an important role to prepare high quality financial statement. Therefore, selecting Audit Firm (Independent Auditor) is a part of process in order to ensure the higher achievement for quality of report. These issues are the intersection of financial reporting quality and audit quality.

II. Theoretical Review

A. Restated Financial Statement

Standing Advisory Group Meeting (SAG, 2008): "We define a 'restatement announcement' as the first public announcement, publication date, or filing date, that either: 1) captures restatement, 2) reveals an intent to restate, and 3) discusses a "concern" that correlates to a subsequent restatement announcement". Previously, academic researches examined restatements from different types of restatements, either unintentional errors or intentional manipulations (i.e., Hennes, Leone, and Miller 2008; Palmrose, Richardson, and Scholtz 2004).

Some reasons for restatements have been used to proxy for earnings management (Efendi, Srivastava and Swanson, 2007; Desai, Krishnamurthy and Venkataraman, 2006; Desai, Hogan and Wilkins, 2006), for accruals quality (Doyle, Ge, and McVay, 2007), for internal company errors from inexperienced financial executives (Aier, Comprix, Gunlock, and Lee, 2005), and for poor corporate governance (Srinivasan, 2005). The occurrence of restated financial reporting is caused by errors in presentation, this will distort the price of shares in capital market.The accuracy and fairness in the presentation of financial statements have been achieved, this will reduce or eliminate the share price distortion. The restated financial statement is to indicate that there is degradation of quality of financial statement.

Those above can be reduced by corporate governance implementation and Audit Firm (Independent Auditor), such as :

1. The high quality of work from internal parties has been involved in the process of preparing the financial statements, such as, avoiding from the lack of independent commissioners' involvement and audit committees.
2. Audit Firm (Auditor characteristics) such as, the big four and non-big four external auditor.

Restatements have been used for internal corporation errors from inexperienced financial executives (Aier, Comprix, Gunlock, and Lee, 2005), and for poor corporate governance (Srinivasan, 2005).

B. Audit Committee and Independent Commissioner as a Proxy of Corporate Governance Mechanism

Internally, the quality of financial statements can be obtained by the agent involvement of the company in preparing financial statements, as well as corporate governance mechanisms. Corporate Governance mechanism is useful to avoid from the financial statements misrepresentation. *Cadbury Committee* define Corporate Governance : *"the system by which organizations are directed and controlled, or a set of rule that define the relationship between shareholders, managers, creditors, the government, employee, and other internal and external stakeholders in respect to their rights and responsibilities"*.
Corporate Governance mechanism, such as Audit Committee and Independent commissioner are parts from the internal process to govern corporation much better. Those two parts have played a key role in improving the quality of financial statements or to avoid the occurrence of restated financial statement. The audit committee and the Independent commissioner should intervene by initiatively involving in the form of policy that can be channeled through the media of meetings with company agents at high level or policy makers.

Audit committee and Independent commissioner contribute to increase level of internal control, this ensure for presentation of financial statements that improve the quality of financial statement presentation (Srinivasan, 2005). It is likely a speech from Chairman of the Securities and Exchange Commission (SEC) about earnings management and the quality of financial accounting practices, Arthur Levitt stated that "… qualified, committed, independent, and tough-minded audit committees represent the most reliable guardians of the public interest" (Levitt, 1998).

C. Audit Firm Size and Audit Rotation

Studies on the economics of auditing and the pricing of audit services provide evidence of the big four as a surrogate for audit quality. The reason is big four audit firms have greater resources, they represent more attractive to provide external audit service than other audit firms.

The other control is through an external mechanism as the market mechanism is done through Audit Firm (Independent Auditors). Audit Firm (Independent Auditor) that aims to focus in the process of preparing the financial statements and also due to that matter. The Audit Firm (Independent Auditors) play an important role in ensuring the financial statements quality. This means that the Audit Firm (Independent Auditor) is the end-gate of financial statements process.

The Audit Firm (Independent Auditors) can be classified according to the quality and reputation that they already have it. With the reputation of Audit Firm (Independent Auditors), they can work perfectly to interprete the whole corporation transaction either complex or simple transaction. It means that big four has high reputation than the other. They will provide assurance to the fairly and truthfully presentation of financial statements.

Williams (1988) argues that corporations change auditors when the contracting environment of the corporation changes, when a corporation desires a more effective auditor or different services, when a company wants to upgrade a tarnished image, or to reduce audit fees. When an auditor change occurs for one of these reasons, the change would generally be expected to benefit shareholders.

The changing of independent auditor can be motivated by corporate expectation to earning management, this is the one of factor from auditor rotation. By changing to a lower quality auditor (i.e. from a Big Six to a non-Big Six firm) following a modified prior audit opinion, larger levels of discretionary current accruals (Davidson III et al. 2005).

D. Previous Research

Loebbecke et al. (1989) study found that there was one of the key contributions to highlighted the potential for audit committee and board governance mechanism to reduce occurrences of financial statement fraud. Agrawal and Chadha (2004) found that the likelihood of restatement of financial statements was significantly smaller in firms that have audit committees and independent commissioners including financial expertise. For that research result, there is a relationship between good corporate governance mechanism and the restated financial statements. This research was inspired by the previous research and this research is to conduct further observations using the variables in the audit committee and independent commissioners that they have a relationship to restated financial statements. Bachtiar and Veronica (2005) use a variable o restated financial statements as the dependent variable by using as a dummy variable. The result shows that the corporate governance mechanism may reduce the errors that will occur, or avoid the mistaken in the financial statements.

Corporate's audit committee is in charge the process of preparing the financial statements and for the presentation of information derived from financial statements can be tested, reliable and relevant. Klein (2002) found a negative correlation between the audit committee with earnings management. Therefore, the existence of an audit committee can avoid the occurrence of the presentation of false and inaccurate. The results of this study indicate that the concept of corporate governance mechanisms will increase the quality of financial statement presentation. At present, this is a global demand of doing good business practices that resulted in a more transparent and the higher quality of information from financial statements.

Implementation of GCG can be seen by through the presence of audit committees and independent commissioners and from GCG can play an important role improving the quality of the presentation of financial statements or to avoid the occurrence of errors in financial statement presentation. This means that will reduce or eliminate the occurrence of restatement of financial statements through that actively involvement of audit committees and independent commissioners in preparing the financial statements.

Audit Firm (Independent Auditor) is a external party to influence the quality of financial statements, because from this party the financial statement can be presented. Therefore, the size of external auditor is to characterize the capacity building from that external auditors. The External Auditors in the big four will have the ability in conducting the good audit process, because they have good human resources, good infrastructure and other system to support that work.Usually, they have had a lot of experience in providing services to corporates or clients.

III. Research Method

Research Design

The design of this study is like a descriptive research, which is a study to find the facts with the interpretation. The descriptive study aims to describe the characteristics of the variables that have a connection or relationship with the object to be observed (Sekaran & Bougie, 2010). This research is also a translation and explanation of a causal association which aims to determine whether there is a correlation between corporate governance mechanism and auditor characteristics with the restated financial statements. With the implementation of corporate governance mechanism will affect the process of financial statements preparation and this will avoid from the restated financial statement. The composition of independent commissioners and audit committee will also have a relationship of financial statement presentation quality and also the independent auditors can influence to.

The composition of independent commissioners and audit committee members are variables that can be associated with the restated financial statements. The composition of independent commissioners and audit committee members can influence the higher the quality of financial reporting. This is to indicate the corporations avoid the occurrence of restated financial statements.

B. Sample

Our sample was selected from audited financial statement by reviewing the statement of auditor opinion and annual report. Annual report is identified by using key-word searches for restatements (e.g., restate, revise, adjust, error). The research is to select the right sample by filterization. Filterization is only to find those corporations that really to make errors and they can be read from their audit statement (audit opinion statement).

IV. Result and Analysis

A. Descriptive Data

The total corporation is listed in Indonesia Stock Exchange that there are 36 corporations to restate financial statement by periods from 2004 up to 2009.Then, the research is to select the right sample by filterization from 36 corporation. By filterization, the research find 11 corporates only.

B. Corporate Governance Mechanism (CGM)

B.1.Audit Committee (AC)

The description of Audit Committee in restated financial statement is shown in table IV.1.:

Table IV.1. Committee Audit

No	Range of Members	# of Corporation	Members Type
1	Up to 3 members	8	1 Ind.Commissioner 2 Outside Corp.
2	More than 3 Members	3	1 ind. Commissioner 3 Outside Corp.

Based on the above table there are 11 corporations facing lower quality in financial presentation. From the 11 corporations, there is a difference between the category of up to three members in audit committee member and more than three members. There are eight corporations in the category of up to three members. There are only three corporations in the category of more than three members. The number of corporations from the category of up to three members is less than to the category of more than three members. This is to indicate even that corporations have audit committee members, they are not free from mistaken of reporting. Audit committee members should contribute to detect if there is mistaken.

From 11 corporations are only three corporations from the category of more than three audit committee members that indicate to be able to detect reporting errors or mistaken. For remaining eight corporations have ability to detect errors reporting from the category up to three members. From this situation that audit committee members is not really to provide a guarantee that prevent from error reporting.

B.2. Composition of Commissioners Board

The composition of commissioners board from outside corporations has been demanded by public. This is to ensure corporations should ethiccally govern their business activities. The outside corporation is called Independent Commissioner (IC) and IC should have more experience, well known and good reputation. The research have found the composition of Board Commissioner that have restated their financial statement, for as below:

Tabel VI.2. Board Commissioner Composition

No	Range level of members	Number of Corporation	Composition
1	Up to 3 members	4	1 IC 2 Not-IC
2	4 up to 5 members	3	1 IC + 4 Not IC (1) 2 IC + 3 Not IC (2)
3	More than 5 members	4	2 IC + 4 Not IC (2) 2 IC + 5 Not IC (1) 2 IC + 6 Not IC (1)

The above table describes that there are three categories, for as follows :

1. Up to three members category contains to one Independent Commissioner (IC) and two Not-Independent Commissioners (Not-IC).

2. Four members up to five members category contains to one Independent Commissioner (IC) and two Not-Independent Commissioners (Not-IC) and the other one contains to two Independent Commissioner (IC) and three Not-Independent Commissioners (Not-IC).
3. More than five members category contains to two Independent Commissioner (IC) and four Not-Independent Commissioners (Not-IC), two Independent Commissioner (IC) and five Not-Independent Commissioners (Not-IC) and the other one contains to two Independent Commissioner (IC) and six not-Independent Commissioners (Not-IC).

The number of corporation is for each category, for as follows:

1. There are four corporations for the first category.
2. There three corporations for the second category.
3. There four corporations for the third category.

This is to indicate even that corporations have one member or two members IC, they do not prevent from mistaken of reporting.

IV.c. Audit Firm Size (Independent Auditor)

IV.c.1. Audit Firm Size

Audit Firm Size (Independent Auditor) should influence the quality of financial statement, it means Independent Auditor from the Big Four (BF) are more qualified than Not-Big Four (Not-BF). BF has many clients, more experince, good reputation, good infrastucture and good human resources. Now, the research have found such as in the below:

Table IV.c.1. Before and At the Restated Financial Statement

No	Description	The Number	Explaination
1	BF Before Restated Not-BF Before Restated	5 6	From Big Four From Not Big Four
2	BF At the Restated Not-BF At the Restated	4 7	From Big Four From Not Big Four

In the above table has indicated that it is not to support that there is a relationship between Audit Firm Size and the quality of financial statement. Because Audit Firm from before restatement indicates that there are five Audit Firm from the Big Four. This number is from 11 audit firm of total restatements. Hence, almost an half from the total number of restatement indicate to have lower quality in financial statement.

After restatement, it is only four from the big four, it means they are four audit firms to contribute to increase the financial statement. That condition is vice versa with Not Big Four Audit Firms, because Not Big Four Audit Firms indicate high quality in audit by finding the erroneous from the previous audit result. This is not good for the reputation of Big Four Audit Firm, because Big Four Audit Firm should have good performance.

IV.c.2. Audit Firm Switch (Rotation)

Restatement of financial statement occurs because Independent Auditor finds something error from the financial statement. The motivation of auditor rotation can increase the quality of financial statetement. Hence, the restated financial statement does happen and it can be seen for the table IV.c.2:

Tabel IV.c.2. Auditor Switch

No	Switch/Without-Switch	Number	Description
1	Switch	1 3 0 0	Among Big Four Among Not-Big Four Big Four – Not-Big Four Not-Big Four – Big Four
2	Without Switch	3 4	Big Four Not-Big Four

The above table indicates that is not strong enough to support Audit Firm switch can increase the quality of financial statement, because the fact is without auditor switch can increase the quality of financial statement. The fact is only four occurences for auditor switching and the others without switching are seven occurences. Moreover, from this table can be seen that Not-Big Four is much better than Big four. Based on literature, Big Four should be much better than Not Big Four. But the research can analyze between Big four and Not-Big Four, the number from Not-Big Four is more than Big Four. Those thing can indicate that it is not always Big Four can perform good quality audit, because there are 7 Not-Big Four can perform to find something error from the financial statement. But for Big Four is only 4 occurence.

V. CONCLUSION, LIMITATION AND SUGGESTION

A.Conclusion

The research result conclude for as below:

1. The research can not proof that CG mechanism ensure to prevent from error reporting, even corporations increase the number of member from Independent Commissioners and Audit committee.
2. The research describes that Audit Firms size is not always to ensure prevent from error reporting. It means Audit Firm from the Big Four are not always much better than Audit Firms from Not-Big Four.
3. 3.The research describes that Auditor switchs (rotations) indicate to ensure corporations can detect or find error reporting.

B. Limitation

The research has some limitations such as:

1. The period is only between 2004 – 2009.
2. The research is only to include the corporations have done the restated financial statement.
3. The research does not classify the type of error from the restated financial statement.
4. The research model is only description research model and the research is only to describe it.

C. Suggestion

1. The research has to extend the periods.
2. The research should include the corporations that do not restate the financial statement.
3. The research should identify and classify the type of error from the restatement.
4. 4.The research should develope the other research mode and more in depth analysis.

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