

# DETERMINANTS OF COMPLIANCE WITH AUDIT COMMITTEE RULES: EVIDENCE FROM INDONESIA

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## Abstract

The main objective of this study is to investigate the extent of public listed companies compliance with the audit committee rules and to examine the association between Indonesian business characteristics and the compliance of public listed companies with the rules. The results indicate that the compliance of public listed companies with the rules is unsatisfactory. In terms of determinants of the compliance, the different types of family control have a different effect on the compliance of public listed companies with the rules. Additionally, public listed companies with politically connected independent commissioner are less likely to comply with the rules. In contrast, public listed companies with large genuine foreign institutional investors are more likely to comply with the rules.

**Keywords:** Compliance, Audit Committee Compliance Index, Indonesian Business Characteristics

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## 1. Introduction

The international donors such as the International Monetary Fund (IMF) and the World Bank actively promoted the Anglo-American corporate governance model to East Asian countries. The IMF prescribes the Anglo-American model as a solution of the East Asian crisis as this model is believed to have superior ability in efficiently allocating resources and monitoring corporate behaviour (Singh and Zammit, 2006; Sam, 2007). Therefore, some crisis-affected countries such as South Korea, Thailand and Indonesia commenced structural reforms of their corporate governance systems with the assistance of the IMF and the World Bank and other international donors, such as the Asian Development Bank (ADB).

There were concerns about the implementation of the Anglo-American corporate governance model in Indonesia. In the academic literature, some scholars (i.e. Patrick, 2001; Lindsey, 2004; Dercon, 2007) argued that the corporate governance reforms in Indonesia were ineffective implementation. These claims were also supported by several empirical studies (e.g. Daniel, 2003; Utama, 2003) that evidence the weak of corporate governance rules implementation in Indonesia. Further evidence of the ineffective implementation of corporate governance rules in Indonesia is noticeable from the low ranking of Indonesia in the most surveys of corporate governance implementation in Asia conducted by international organizations such as Credit Lyonnaise Securities Asia (CLSA), the World Bank, and the

IMF. For example, based on the Reports on Observance of Standards and Codes (ROSC) Financial Services Assessment Program (World Bank, 2010), in some respects, the Indonesian corporate governance framework is not substantially different from the OECD principles. However, corporate governance implementation in Indonesia lagged behind other countries in Asia and the South Pacific Region and adherence to corporate governance regulation remains a problem (World Bank, 2010). In sum, the Indonesian government has introduced a range of corporate governance reforms aimed to implement the Anglo-American model; however, there have been serious problems in the implementation.

In the extant literature, there are a few empirical studies that examine the effect of the specific Indonesia business environment such as family control, collusion between politician-bureaucrat with businesses and foreign institutional investors on compliance with corporate governance regulation. The main reason is that most of the prior studies in corporate governance employ agency theory. The use of the agency theory as the main theory in corporate governance studies has resulted in such studies solely focusing on the some factors related to agency costs (i.e. agency cost of equity, agency cost of debt) and board characteristics. In fact, the agency problem in a developing country in Asia is different from that in a developed country as the agency problem in developing country occurs between controlling shareholders and minority shareholders (type 2 of

agency problem) (Young *et al.*, 2008; Jaggi *et al.*, 2009; Chen *et al.*, 2011). In addition, corporate governance practice, which consists of interrelated mechanisms, is affected also by various actors (Cohen *et al.*, 2004). As a result, the pertinent institutional factors in emerging economies, such as family control, foreign institutional ownership and collusion between businesses and politicians, have been ignored in most prior studies. In fact, the unique business characteristics in one country are important factors that affect corporate governance practice (Yoshikawa and McGuire, 2008; Nakamura, 2011).

Among the Anglo-American corporate governance mechanisms introduced in Indonesia, we focus on the issue of adherence to the audit committee rules because of some reasons. First, audit committee has been widely accepted in many countries as a common mechanism of corporate governance; however, the implementation of audit committees in Indonesia is relatively new (only started in 2000). This clearly lags behind other countries such as Malaysia, which implemented such requirements as early as 1993 (Kuppusamy *et al.*, 2003). Second, the BAPEPAM issued two rules related to audit committee that strengthened the audit committee regulations by providing standard guidelines for audit committee formation (BAPEPAM, 2004) and disclosure (BAPEPAM-LK<sup>1</sup>, 2006). However, there is limited evidence concerning the extent of the compliance of public listed companies with those rules. Third, it is possible that the establishment of the audit committee is perceived to be more for cosmetic purposes in order to give a positive image rather than actually monitoring of the firms (Cohen *et al.*, 2004; Haron *et al.*, 2005). Therefore, the objective of this study is to examine the extent of public listed companies' compliance with recent Indonesian Capital Market Supervisory Agency rules concerning audit committees and to examine the association between Indonesian business characteristics and the compliance of public listed companies with audit committee rules.

We assume that this study makes several contributions to the extant corporate governance literature. First, the study employs multiple theories (i.e. bundle of corporate governance theory, altruism, and institutional theory) to complement the agency theory. As suggested by some scholars (i.e. Turley and Zaman, 2004; Aguilera *et al.*, 2008; Cohen *et al.*, 2008), the use of multiple theories enables reconciliation of the conflicting findings in the prior studies in examining the interrelation among corporate governance mechanism. Second, this study examines some unique variables in Indonesia that have not been widely tested by prior studies in compliance study, such as two types of family control (family-controlled firm with family members on the boards versus family-controlled company with professional management), politically connected independent commissioner, and authenticity of large

foreign institutional investors. Third, this study examines determinants of public listed companies' compliance with audit committee rules in mandatory setting in Indonesia where legal enforcement is weak, and, possibly, specific business characteristics may influence the compliance.

This remainder of paper is structured as follows. The next section presents a review of theoretical literature and hypotheses development. Section 3 presents research method. The fourth section presents the empirical results and discussion. Section 5 presents a conclusion and limitation of the study including the possibilities for future study.

## 2. Literature Review

### 2.1 Theoretical Literature

In line with suggestion of some scholars (i.e. Cohen *et al.*, 2008; Young *et al.*, 2008), we assume that single agency model is not adequate to describe corporate governance in all national. The use of the multiple theories will provide a useful basis for reconciliation of the conflicting findings in the existing agency-based corporate governance studies (Cohen *et al.*, 2008; Ahrens *et al.*, 2011). Some scholars (e.g. DeZoort *et al.*, 2002; Cohen *et al.*, 2008; Bédard, and Gendron, 2010) argue the need for corporate governance studies to employ multiple theories, such as institutional theory, resource dependence theory and managerial hegemony. Therefore, in this study several theories are employed to complement the agency theory, such as bundle of corporate governance theory, agency theory, institutional theory and resource dependence theory.

In addition to multiple theories, some scholars (e.g. Filatotchev, 2007; Aguilera *et al.*, 2008; Ahrens *et al.*, 2011) advocate that corporate governance research need to employ an "open system" approach that enables an examination of the interdependence between the organizational environment and corporate governance practice. The use of this approach overcomes the inability of the agency theory to accurately compare and explain the diversity of the corporate governance arrangements across different institutional settings (Aguilera *et al.*, 2008). Therefore, we assume that the use of the "open system" enables this study to examine effect of some Indonesian pertinent business characteristics, such as family control, foreign institutional ownership and collusion between businesses and politicians on the compliance with audit committee rules.

### 2.2. Hypotheses Development

#### 2.2.1. Family control

In the Indonesian environment, it is more common to see family members having a role as members of the board of directors, board of commissioners, or both.

More often than not, the head of the board of commissioners represent the controlling party of the company or someone very close with controlling shareholders (Husnan, 2001, Hanani, 2005). In this circumstance, there is the unification of control and ownership by family as controlling shareholder. As family ownership increases the conflicts between managers and shareholders is likely to be reduced. This is called as the convergence-of-interest hypothesis or the alignment effect (Jensen and Meckling, 1976). However, the presence of family ownership or insider ownership also creates costs associated with it, and that might offset the gains of convergence-of-interest. When family members on boards have a substantial fraction of firm shares, it gives them sufficient voting power or influence that enables them to pursue their personal agenda (non-value maximizing) without jeopardizing their employment and remuneration, which is called the entrenchment hypothesis (Fama and Jensen, 1983). We assume that effect of family control on the compliance with audit committee rules could be explained based on either alignment effect or entrenchment effect.

Based on alignment effect, there will be less information asymmetric, less conflicts, and reduces issues related to hierarchical organization structures because family is actively engaged in the daily activities of the company (Niemi, 2005). In this circumstance, the agency problems type 1 decreases causing Anglo-American corporate governance is less effective. As a result, family-controlled firms tend to be less concerned with the Anglo-American corporate governance and to maintain personal control rather than rely on the formalized procedure to monitor the company. Hence, family-controlled firms might not welcome the introduction of Anglo-American corporate governance mechanisms, such as the audit committee and independent director.

The assumption that family firm has low or zero agency costs as the interest of owner and management converge depends on another factor, namely altruism (Chua *et al.*, 2003; Chrisman *et al.*, 2004; Chrisman *et al.*, 2005). The altruism concept is drawn from the stewardship theory in the context of family firms, and could be defined as unselfish concern and devotion to others without expected return (Corbetta and Salvato, 2004). The altruistic behavior through family ties might create a sense of togetherness and reciprocity that permeated throughout the firm and led to reduced agency costs (Karra *et al.*, 2006). Hence, altruism might make family firms loath to adopt formal corporate governance or even if family firms adopt formal governance mechanisms, the parental altruism can reduce their effectiveness (Schulze *et al.*, 2001).

Based on entrenchment theory, the election of family members or crony as board member might cause ineffective monitoring of board. The ineffective of board monitoring might also cause less effective of audit committee. In the context of this study, less

effective of audit committee is indicated by the low compliance of family firm with audit committee rules. In short, family firms tend to implement weak corporate governance in order to keep a chance for entrenchment.

Based the above explanation, we propose the following testable hypothesis:

**H<sub>1</sub>** *Family controlled companies with family members represented on the boards are less likely to comply with audit committee rules.*

Even if most family controlled companies do not have separation between ownership and control as hypothesized above, it is possible also that the family controlled firms hire professional executives, who are non-family member, to run their business. There are plausible explanations as to why family firms employ the non-family professional executives such as the increasing firm size requires more executives with higher level of professionalism and external knowledge and expertise (Daily and Dollinger, 1992; Klein and Bell, 2007), the non-family professional executive is needed by family business owner to prepare a family member of the next generation as a potential future family manager (Poza *et al.*, 1997; Le Breton-Miller *et al.*, 2004), and the non-family professional executive is needed by family business owner to serve as a mediator in case of family conflicts (Dyer, 1989).

The appointment of non-family executives may then increase potential agency costs, which is characterized by divergent interest, informational asymmetric and bounded rationality (Chua *et al.*, 2003). In terms of divergent interest, the appointment of non-family executive followed by delegation of more authority to him will increasingly resemble a non-family firm (Chua *et al.*, 2003). The appointment of non-family executives causes the separation of the owner and the management that is one driver of the agency costs. The personal goal of non-family professional executives might differ strongly from those of family owner as the family owner usually has stronger long-term orientation than non-family professional executive (Block, 2011). The non-family executive might tend to use this autonomy in order to serve his/her own interests and goals that might not align with those of the family (Bhattacharya and Ravikumar, 2004). Besides the potential divergence of interest, the more non-family executives involved in the family business might potentially increase information asymmetry (Chua *et al.*, 2003). Larger non-family executives also might cause stronger impact of bounded rationality as family owner has to monitor more people with more transactions in which the family owners are not directly involved. In addition, the presence of non-family executive also might reduce the altruistic behavior in family firm. The absence of family bond as basis for reciprocal altruism will increase the incentive for non-family executive to act opportunistically (Chua *et al.*, 2003).

We argue that the increasing of agency costs due to the presence of non-family executives might cause the formal corporate governance mechanisms such as independent commissioner and audit committee are more effective. There are three possible reasons for the reliance on formal mechanisms. Firstly, as the family member is absent from day to day firm's activities and serves as a passive shareholder; the family tends to insist on utilising formal mechanisms to protect their investment. Secondly, professional managers themselves are likely to rely on the formal mechanisms to give feedback for their performance. Finally, corporate governance mechanism such as board independence and monitoring might serve as a solution for any family rivalry, especially, in the case where the founder is not actively managing the firm (Bertrand *et al.*, 2008).

Based the above explanation, we propose the following testable hypothesis:

**H<sub>2</sub>** *Family controlled companies with non-family members represented on the boards are more likely to comply with audit committee rules.*

### **2.2.2 Politically-Connected Independent Commissioner**

Indonesia's two-tier system results in companies having two independent boards: a board of commissioners and a board of directors. The existence and function of the independent commissioner in the board of commissioners are similar to the non-executive members of the board of directors under the one tier system. In the relationship based system in East Asia, the function of board of directors as resource dependence are more pronounced than function as monitoring and control (Young *et al.*, 2001).

Consistent with Young *et al.* (2001), the function of board directors in Indonesia seems to emphasize on resource dependence role. It can be seen that, in Indonesia, some of independent commissioners, who also sit in the audit committees, are former or current bureaucrat (government official) or retired army (Husnan, 2001; Zaini, 2002). The presence of this type independent commissioner is in line with resource dependence theory. The presence of this politically-connected independent commissioner might be intended to provide company a special relationship with elite politic in order to get some kind of protection or special treatment, such as access to outside capital, and preserves monopolistic strategies (Husnan, 2001).

We assume that the politically-connected independent commissioner might have a negative association with the company's compliance with audit committee rules. There are some reasons underlying the argument. Firstly, the politically-connected commissioner might provide benefit to the company because of their knowledge and experience with government procedures, their insights in government

actions, their ability to enlist the government for the firm's interest at the expense of competitors, or to forestall government action inimical to the firm (Agrawal and Knoeber, 2001). In the context of public policy, it is possible that the company might receive selective enforcement (Pittman, 1977). Thus, it is possible that IDX or BAPEPAM might be reluctant to enforce the implementation of audit committee rules to the company that have politically-connected independent commissioner. Secondly, most of the politically-connected independent commissioners often lack the competency to perform the oversight duty. For example, Chen *et al.* (2006) find that directors affiliated with various layers of governmental agencies in China mostly do not possess business experience or expertise in law, accounting, or finance. They might not have either any prior working in finance or accounting or education background in accounting or both. In another study, Young *et al.* (2001) find that outside directors in Hong Kong and Taiwan strictly for legitimacy purpose and they often lacked the ability to provide advice and counsel the management. Similarly, Zaini (2002) argue that the politically-connected independent commissioners in Indonesia mostly lack the skill, experience, and education required to be an independent commissioner and head of the audit committee member. Consequently, the politically-connected independent commissioner might not effectively perform the monitoring function. Thirdly, Rosser (2003) argues that politician/bureaucrat in Indonesia tend to block the corporate governance reform. The politician/bureaucrat has interest in maintaining the old system that enables them to hide the nature of their relationship with the leading business groups and also to exploit the SOE. Based the above argument, we propose the following testable hypothesis:

**H<sub>3</sub>** *Public listed companies with politically-connected independent commissioner are less likely to comply with audit committee rules.*

### **2.2.3. Foreign Institutional Investor**

In the extant literature, it is widely accepted that foreign institutional investors might play role in enhancing effectiveness of formal corporate governance mechanisms in developing countries. Foreign institutional investors might be more resistant and more likely to push for transparency and shareholder protection (Peng, 2003), imposing their own company policies, internal reporting systems and principles of information disclosure on acquired firms in developing country (OECD, 2002), and agents of transformation in diffusing specific asset, knowledge and culture, including governance practices, in developing countries (Chevalier *et al.*, 2006). The role of foreign institutional investors in improving corporate governance practice in developing countries is in line with the institutional theory. In this context,

foreign institutional investors serves as exogenous pressure to introduce corporate governance practice that are socially legitimate or widely perceived as appropriate and effective (Aguilera and Cuervo-Cazurra, 2004). Thus, the pressures from foreign institutional investors cause mimetic isomorphism among companies (Yoshikawa and Rasheed, 2009).

We assume that not all types of foreign institutional investors affect corporate governance. We argue that, in exploring the role of foreign institutional investors, one need to be cognizant whether it is a genuine investment and also the size of the investment matters. The genuine aspect of foreign institutional investors is an important because some of those foreign investors might in actual fact be off-shore companies owned by Indonesians themselves (World Bank, 2010). Some of those foreign investors might be special purpose entities (SPE) owned by Indonesians. Therefore, it is important to trace the ultimate shareholders of the foreign institutional investors. Because it might not make sense, if the foreign institutional investors are owned by Indonesians particularly the family as controlling shareholders. This type of foreign institutional investors is not an independent from the company. In addition, they are not resistant from the common corporate governance practice in Indonesia as the ultimate owners are Indonesian.

Besides the genuineness of the foreign institutional investor, another attribute that must be considered is the amount of shares owned by the foreign institutional investors. Typically, foreigner investors with large stake ownership have significant

power to influence company policy and thus the incentive for monitoring (Chen *et al.*, 2007). Empirical studies evidence the role of large shares owned by foreign investors on corporate governance in developing countries. For example, Chevalier *et al.* (2006) find that large foreign ownership participation is likely to be positively related to better corporate governance practices. Similarly *et al.* (2006) find that foreign investors, with large ownership and long term involvement, have positive effect on financial performance. Based the above argument, we propose the following testable hypothesis.

**H<sub>4</sub>** *Public listed companies with large genuine foreign institutional ownership are more likely to comply with audit committee rules.*

### 3. Research Method

#### 3.1 Sample Selection

Data of this study was panel data that covers the period from 2006 to 2008. The starting year was 2006 because the BAPEPAM-LK rule No. X.K.6 concerning mandatory disclosure of information related to audit committee effectively took effect in that year. Thus, this mandatory disclosure enables an examination of actual audit committee practice. During the period 2006-2008, there were totally 1129 firm-year observations. As can be seen in Table 1, this initial sample was then reduced due to some reasons as. The procedures resulted in a final sample of 828 firm-year observations.

**Table 1.** Sampling Selection Procedure

Sample selection	Number
Total number of listed companies from 2006 to 2008 at IDX	1129
Less:	
Listed banks during the period 2006-2008	(69)
Listed state owned enterprises during the period 2006-2008	(27)
Companies listed after 2006	(41)
Companies with cross listing during the period 2006-2008	(24)
Delisting and merger during the period 2006-2008	(9)
Incomplete annual report during the period 2006-2008	(131)
Final sample of listed companies during the period 2006-2008	828

#### 3.2. Research Models

To test the hypotheses, we developed two multiple regression models. Each model specification is as follows.

Model 1

$$ACCIT_{it} = \beta_{0it} + \beta_1 FMLBOCD_{it} + \beta_2 GLFRG_{it} + \beta_3 POLIC_{it} + \beta_4 ICED_{it} + \beta_5 BOC_{it} + \beta_6 BCS_{it} + \beta_7 AUD_{it} + \beta_8 LOSS_{it} + \beta_9 LEV_{it} + \beta_{10} SIZE_{it} + \varepsilon_{it}$$

Model 2

$$ACCIT_{it} = \beta_{0it} + \beta_1 PROFBOCD_{it} + \beta_2 GLFRG_{it} + \beta_3 POLIC_{it} + \beta_4 ICED_{it} + \beta_5 BOC_{it} + \beta_6 BCS_{it} + \beta_7 AUD_{it} + \beta_8 LOSS_{it} + \beta_9 LEV_{it} + \beta_{10} SIZE_{it} + \varepsilon_{it}$$

Where: FMLBOCD = family-controlled company with family members on the boards; PROFBOCD = family-controlled company with professional management; GLFRG = genuine large foreign institutional investor; POLIC = politically connected independent commissioner; ICED = independent commissioner financial expertise; BOC = proportion of independent commissioners; BCS = board of commissioners size; AUD = audit quality; LOSS = loss; LEV = leverage; SIZE = company size;  $\varepsilon$  = error term.

In some extent, the two models use similar variables. Model 2 is different from model 1 as the variable of FMLBOCD in model 1 is replaced by variable PROFBOCD in model 2. The model 1 is intended to test hypothesis H<sub>1</sub>, while model 2 is for testing of hypothesis H<sub>2</sub>.

In the models, we control for the effects of other factors related to the compliance with audit committee rules, such as proportion of independent commissioner (e.g. Chau and Leung, 2006; Chen *et al.*, 2009; Baxter, 2010), financial expertise of independent commissioner (e.g. BRC, 1999); board size (e.g. Webb, 2008; Rainsbury *et al.*, 2008), company size (e.g. Braiotta and Zhou, 2006; Webb, 2008), audit quality (e.g. Willekens *et al.*, 2004; Joshi and Wakil, 2004), loss (e.g. Klein, 2002), and leverage (e.g. Menon and Williams, 1994; Braiotta and Zhou, 2006).

### 3.3. Variables Measurement and Data Source

#### 3.3.1. Audit Committee Compliance Index

We developed audit committee compliance index (ACCIT) to measure the level compliance of public listed companies with audit committee rules. The ACCIT consists of requirements of audit committee rules extracted from two recent BAPEPAM rules, namely, BAPEPAM (2004) regarding membership requirements and job duties (10 requirements) and BAPEPAM-LK (2006) regarding audit committee disclosure (3 requirements). Thus, in total, there are 13 requirements extracted from those rules. To measure the level of compliance, this study utilized a binary scoring system. If any company complied with a particular requirement, it got score of 1 and 0 otherwise. The level of a particular compliance of company was obtained from the sum of all requirements. In developing the index, we employed equal weight approach. It meant that each sub index (BAPEPAM (2004) and BAPEPAM-LK (2006)) had equal weight. The equal index was chosen as it is transparent and relatively objective (Van den Bergh and Levrau, 2003; Black *et al.*, 2006; Florou and Galarniotis, 2007).

**Table 2.** Weight and Data Source of Audit Committee Compliance Index Total (ACCIT)

No.	Requirements	Rules	Data source	Weight
	<i>Structure, membership and independency</i>			
1	Comprise at least three members		AR; CAI	
2	Members shall be external independent parties.		AR; CAI	
3	Chairman is an independent commissioner.		AR; CAI	
4	One member shall have educational background in accounting or finance.	BAPEPAM (2004)	AR; CAI	
	<i>Job duties</i>			
5	Audit committee charter.		AR; CAI	
6	Examining the financial information.		AR; CAI	
7	Reviewing the compliance of company with regulations.		AR; CAI	50 %
8	Reviewing of internal auditor's work.		AR; CAI	
9	Reporting of risks and risk management implementation.		AR; CAI	
10	Scrutinizing and reporting of complaints.		AR; CAI	
	<i>Disclosure</i>			
11	Name, position and brief profile of the audit committee member.		AR	
12	Frequency of meeting and attendance of each member.	BAPEPAM-LK (2006)	AR	50%
13	Brief report of audit committee activities.		AR	

Notes: AR= annual report; CAI= announcements of company to the IDX

#### 3.3.2. Genuine Large Foreign Institutional Investor

In measuring of this variable, it was necessary to define the size of stakes that represent large foreign institutional investors. We focused on the first top one foreign institutional investor that had ownership of at least 20 percent as proxy of large shareholders. The use a cut-off level of 20 percent is consistent with

prior studies (e.g. Sato, 2004; Chevalier *et al.*, 2006; Tribo *et al.*, 2007; Achmad *et al.*, 2009).

After defining the large foreign institutional shareholders, it was necessary to identify whether the large foreign institutional investors were genuine. Except for banks, there was no regulation in Indonesia to disclose the ultimate shareholder (World Bank, 2010). The use of database provider, such as

Bloomberg, to trace the ultimate shareholder was not useful since Bloomberg categorized the suspected foreign institutional investors as “internal transaction”, and, as such, no further information was available. Therefore, this study collect information from several resources such as such as annual report and announcements of public listed company to the IDX, reliable business magazines or news, and business profile issued by agency where institutional investors were located.

As can be seen in Table 3, the suspected foreign investors are Indonesian offshore companies in the form of special purpose interest and also well known banks that usually act as custodian bank on

behalf of the Indonesian shareholders. The special purpose interests are formed in tax haven countries, while the banks, which act as nominee, usually operates in Singapore. Singapore and British Virgin Islands are the most favorite jurisdictions for Indonesian off shore companies. We argued that the Indonesian offshore companies did not enhance corporate governance practice of listed companies in Indonesia. Therefore, the public listed company, which had foreign institutional investors with large stake (20 percent and above) and genuine (not Indonesian offshore companies or bank acting as custodian on behalf of Indonesian), was scored 1 and 0 otherwise.

**Table 3.** List of Jurisdiction of Indonesian Offshore Company

No.	Jurisdiction	No. Observation	Percentage
1	Singapore	16	29
2	British Virgin Islands	16	29
3	Hong Kong	7	13
4	Mahe, Seychelles	4	7
5	Labuan Malaysia	3	5
6	Cayman Islands	2	4
7	Mauritius	2	4
8	Samoa	2	4
9	Cook Islands	1	2
10	Charlestown, Nevis	1	2
11	Jersey, Channel Islands	1	2
12	Marshall Islands	1	2
	<i>Total</i>	56	100

Source: Compiled by the author

### 3.3.3. Other Independent Variables of Interest

Table 4 presents a summary of measurement of all the variables.

**Table 4.** Summary of the Variable Measurements

Main Variables	Measurement
ACCIT	A composite index consisted of 13 mandatory requirements
GLFGR	1 if top one foreign institutional investor was genuine and large (ownership is at least 20 percent), 0 if otherwise.
FMLBOCD	1 if at least one family member is a board member, 0 if otherwise.
PROFBOCD	1 if firm was controlled by family (ownership is at least 20 percent) and was managed by professional, 0 if otherwise.
POLIC	1 if one or more of independent commissioner was retired army or current/retired bureaucrat, 0 if otherwise.
Control Variables	
ICED	1 if independent commissioner as audit committee chair had educational background in accounting or CPA holder, 0 if otherwise.
BOC	Number of independent commissioners divided by total number of board of commissioner members.
Control Variables	
BCS	Number of board commissioner members.
AUD	1 if listed companies was audited by Big 4, 0 if otherwise.
LOSS	1 if listed companies had a negative net income in the current year, 0 if otherwise
LEV	Debt ratio = total debt to total assets
SIZE	Log natural of year-end of total asset

For the family-controlled company with family member on the boards (FMLBOCD), public listed company was scored 1 if one or more of family members sit on board of director, board commissioner, or both, and it got score 0 otherwise. As family might control the company with small stakes as through pyramid structure, we did not determine certain cut-off level of family ownership. Data source for the measurement of this variable were the annual report (i.e. biography of directors and commissioners and ownership structure of the company), prospectus and the announcement of company to the IDX (i.e. monthly report of shares ownership prepared by share registrar). In terms of the family-controlled company with professional management (PROFBOCD) variable, the public listed company was scored 1 if the company was controlled by family with ownership 20 percent and above and no family members on the board, and it got score 0 otherwise. The use of 20 percent as cut off was to ensure that the family was actually the controlling shareholders with large stakes, but they intentionally did not place any member in the board commissioners, board directors, or both. With regard to the politically connected independent commissioner (POLIC) variable, the public listed company was scored 1 if one or more of independent commissioners were retired army or retired or current bureaucrat and scored 0 otherwise. Data source for measuring this variable was annual report of the company, especially on the part of biography of board director and board commissioner members.

## 4. Empirical Results and Discussion

### 4.1. Level of Compliance

Table 5 shows the listed companies' compliance with each audit committee requirement for each year from

2006 to 2008. As envisaged it is noted that none of the requirements are fully complied (100 percent) by all public listed companies during this period observation. The level of compliance with membership rules is highest compared to the other aspects of audit committee rules. This finding is consistent with Utama and Leonardo (2004) who found high compliance in the aspect of membership. This may be due to the monitoring of the IDX and the BAPEPAM and their emphasis on whether audit committees of public listed companies have met the membership requirements rather than whether the audit committees have been carrying out their functions (see IDX annual report 2004). Another factor that may have contributed to the high adherence to the membership rules is the similarity of the membership requirements stipulated in the BAPEPAM (2004) and the prior requirement (i.e. JSX, 2001). The higher compliance with membership aspect compared to the other aspects might present early indication that the presence of the audit committee is for symbolic purpose as the listed companies. Public listed companies just tend to indicate that their audit committees satisfactorily meet the membership requirements, but they cannot show that the audit committees have done their assigned job. This finding is in line with the institutional theory. As noted by Cohen *et al.* (2008) that an implication of institutional theory is audit committee might emphasize ceremonial role. Audit committee members tend to become similar to others within same industry and elected based their credentials without considering their ability to effectively monitor management. As a result, the adoption of audit committee is primarily to enhance external legitimacy but not necessarily coupled with actual monitoring functions (Cohen *et al.*, 2008; Beasley *et al.*, 2009; Carcello *et al.*, 2011).

**Table 5.** Level of Public Listed Companies' Compliance with Audit Committee Rules

Requirements	Level compliance (%)				
	2006	2007	Δ	2008	Δ
<i>Structure, membership, and independency</i>					
1. Comprise at least three members	96	98	2	97	1
2. Members shall be external independent parties	86	88	2	86	0
3. Chairman is an independent commissioner	96	98	2	98	2
4. One member shall has education background in accounting or finance	92	95	3	95	3
<i>Job duties</i>					
5. AC Charter	17	20	18	24	41
6. Examining the financial information	81	89	10	90	11
7. Reviewing the company's compliance with regulations	57	62	9	68	19
8. Reviewing of internal auditor's work	62	71	15	75	21
9. Reporting of risks and risk management implementation	25	36	44	40	60
10. Scrutinizing and reporting of complain	8	10	25	11	38
<i>Disclosure</i>					
11. Name, position, and brief profile of the AC member	42	54	29	60	43
12. Frequency of meeting and attendance of each member	17	29	71	32	88
13. Brief report of AC activities	58	67	16	71	22

Source: Compiled by the author



## 4.2. Determinants of the Compliance

We employed feasible generalized least squares (FGLS) as both models contain autocorrelation and heteroscedasticity problems. FGLS could be used to remedy heteroscedasticity and autocorrelation as well (Wooldridge, 2009). Table 6 presents the results of estimation using the FGLS method for the both models.

In model 1, most coefficients of the independent variables meet the expectations. The family controlled company with family members on the boards (FMLBOCD) and politically connected independent commissioner (POLIC) are negatively significant associated with audit committee compliance index total (ACCIT). This findings support the hypotheses  $H_1$  and  $H_3$ . The negative significance of the politically-connected independent commissioner (POLIC) provides evidences that the role of independent commissioner emphasizes the harnessing of external resources (resource dependency theory) rather than the monitoring role (agency theory) explaining the decreased level of adherence to such rules. Meanwhile, as expected, genuine large foreign institutional investor (GLFRG) is positively and significantly associated with audit committee compliance index total (ACCIT). This finding supports  $H_4$  that genuine large foreign institutional investor (GLFRG) are more likely to comply with audit committee compliance index total (ACCIT).

Model 2 was developed to test the hypothesis  $H_2$  by replacing family controlled company with family members on the boards (FMLBOCD) variable with family controlled company with professional management (PROFBOCD) variable. The replacement was needed to know the different effect on audit committee compliance index total (ACCIT). As expected, the result indicates that family controlled company with professional management (PROFBOCD) shows significant positive association with audit committee compliance index total (ACCIT). The positive significant family controlled company with professional management (PROFBOCD) is in contrast to the family controlled company with family members on the boards (FMLBOCD) which has negative significant association with audit committee compliance index total (ACCIT). This finding supports hypothesis  $H_2$ . This results evidences that different types of family control has different effect on public listed companies' compliance with audit committee rules. This finding implies that the combined ownership and control in the hand of family members might serve as an alternative corporate governance mechanism that may relegate formal corporate governance mechanism such as audit committee as less effective.

## 4.3. Sensitivity Analysis

To check the robustness of the results, several sensitivity analyses were performed including using alternative measurement of foreign institutional investor, adding year dummy, and addressing endogeneity concerns.

### 4.3.1. Use Alternative Measurement of Foreign Investor Ownership

One of the distinguishing features of this study with other prior studies is the measurement of foreign institutional investor variable that considers the authenticity aspect. Considering the Indonesian environment, authenticity aspect is important as many foreign institutional investors are Indonesian offshore companies (World Bank, 2010). As presented in earlier section, genuine large foreign institutional investor (GLFRG) has positive significant association with audit committee compliance index total (ACCIT) that supports  $H_4$ . For the sensitivity analysis, we used a different measurement of foreign institutional investor that ignores the authenticity aspect. The foreign institutional investors were measured by total percentage of shares held by foreign investors (FRGOWN). Even though, this measurement has been widely used in prior studies (e.g. Sarkar and Sarkar, 2000; Colpana, Yoshikawab, Hikinoc, and Miyoshi, 2007; Chien, 2008), the use of this measurement might produce different result in Indonesia environment. This measurement pooled total ownership owned by foreign institutional investors, whereas some of them are Indonesian offshore companies. Thus, compared to genuine large foreign institutional investor (GLFRG), we expect that the total percentage of shares held by foreign investors (FRGOWN) is less significantly associated with audit committee compliance index total (ACCIT).

As can be seen in Table 6, as expected, the replacement of the variable genuine large foreign institutional investor (GLFRG) with total percentage of shares held by foreign investors (FRGOWN) provides opposite result. In model 1, genuine large foreign institutional investor (GLFRG) has positive significant association with audit committee compliance index total (ACCIT). In contrast, in the model 3, total percentage of shares held by foreign investors (FRGOWN) is not significant and even the coefficient sign is negative. In sum, this finding provides evidence the inappropriateness of measurement of foreign institutional investor that solely uses total percentage shares without identifying the authenticity of the foreign investors. It is clear that not all foreign institutional investors in Indonesia enhance corporate governance practice. Therefore, this research demonstrates the applicability of the institutional theory in understanding corporate governance in Indonesia.

**Table 6.** Results of Feasible Generalized Least Squares (FGLS) Method Dependent Variable: Audit Compliance Index Total (ACCIT)

Variable	Exp. Sign	Without Year Dummy			With Year Dummy			With Lagged Dependent Variable		
		Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
ACCIT <sub>(t-1)</sub>	+	-	-	-	-	-	-	0.629*** (0.000)	0.853*** (0.000)	0.637*** (0.000)
FMLBOCD	-	-0.040*** (0.000)	-	-0.051*** (0.000)	-0.036*** (0.005)	-	-0.050*** (0.000)	-0.010*** (0.000)	-	-0.015*** (0.000)
PROFBOCD	+	-	0.029** (0.021)	-	-	0.032* (0.094)	-	-	-0.005 (0.551)	-
FRGOWN	+	-	-	-0.000 (0.412)	-	-	-0.000 (0.408)	-	-	0.000 (0.760)
GLFRG	+	0.021** (0.026)	0.038*** (0.000)	-	0.034*** (0.009)	0.050*** (0.000)	-	0.023*** (0.000)	0.014*** (0.000)	-
POLIC	-	-0.023*** (0.002)	-0.021*** (0.003)	-0.025*** (0.001)	-0.021** (0.050)	-0.020* (0.065)	-0.022** (0.036)	-0.033*** (0.000)	-0.018*** (0.000)	-0.025*** (0.000)
<i>Control Variable</i>										
ICED	+	0.031*** (0.000)	0.025*** (0.000)	0.029*** (0.000)	0.036*** (0.000)	0.036*** (0.000)	0.036*** (0.000)	0.039*** (0.000)	0.044*** (0.000)	0.037*** (0.000)
BOC	+	0.086*** (0.000)	0.077*** (0.000)	0.077*** (0.000)	0.069** (0.031)	0.074** (0.020)	0.072** (0.027)	0.053*** (0.000)	0.025*** (0.006)	0.045*** (0.000)
BCS	+	0.014*** (0.000)	0.014*** (0.000)	0.014*** (0.000)	0.011*** (0.000)	0.011*** (0.000)	0.013*** (0.000)	0.000 (0.552)	-0.006*** (0.000)	0.000 (0.990)
AUD	+	0.065*** (0.000)	0.067*** (0.000)	0.069*** (0.000)	0.063*** (0.000)	0.065*** (0.000)	0.070*** (0.000)	0.023*** (0.000)	0.010** (0.011)	0.022*** (0.000)
LOSS	-	-0.006 (0.269)	-0.007 (0.173)	-0.006 (0.258)	-0.002 (0.789)	-0.002 (0.795)	-0.003 (0.693)	-0.040*** (0.000)	-0.025*** (0.000)	-0.040*** (0.000)
Sqrt LEV	+	-0.055*** (0.000)	-0.054*** (0.000)	-0.055*** (0.000)	-0.037** (0.039)	-0.037** (0.040)	-0.042** (0.025)	-0.011** (0.021)	0.014* (0.081)	-0.015*** (0.007)
SIZE	+	0.034*** (0.000)	0.034*** (0.000)	0.033*** (0.000)	0.027*** (0.000)	0.027*** (0.000)	0.027*** (0.000)	0.012*** (0.000)	0.007*** (0.000)	0.014*** (0.000)

Table 6. (continued)

Variable	Exp. Sign	Without Year Dummy			With Year Dummy			With Lagged Dependent Variable		
		Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
<i>Year Dummy</i>										
2007	+	-	-	-	0.045*** (0.000)	0.045*** (0.000)	0.045*** (0.000)	-	-	-
2008	+	-	-	-	0.059*** (0.000)	0.060*** (0.000)	0.060*** (0.000)	-	-	-
Constant		0.054* (0.069)	0.027 (0.326)	0.077*** (0.010)	0.1134*** (0.006)	0.082** (0.041)	0.128*** (0.002)	0.085*** (0.000)	0.034*** (0.007)	0.071*** (0.000)
Wald chi2(10)		1275.14	1284.73	972.42	-	-	-	-	-	-
Wald chi2(11)		-	-	-	-	-	-	1.36e+07	244711.01	34963.70
Wald chi2(12)		-	-	-	533.35	544.16	521.33	-	-	-
Prob > chi2		0.000	0.000	0.000	0.000	0.0000	0.000	0.000	0.000	0.000
Observation		828	828	828	828	828	828	552	552	552

Notes: *p*-value in parentheses; \*, \*\*, \*\*\* indicates significance at the 0.10, 0.05 and 0.01 respectively;  $R^2$  for fixed effects and random effects are overall; FMLBOCD = family controlled company with family members on the boards; PROFBOCD = family controlled company with professional management; FRGOWN=total percentage shares held by foreign investors; GLFRG = genuine large foreign institutional investor; POLIC=politically connected independent commissioner; ICED= independent commissioner financial expertise; BOC = proportion independent commissioner; BCS = board commissioner size; AUD = audit quality; LOSS = loss; LEV= leverage; SIZE = firm size.

### 4.3.2. Adding Year Dummy

For robustness of the result, the regression is re-estimated by adding year dummies as independent variable. The year dummy is used to accommodate unobserved heterogeneity that vary across time rather than across subject such as technological changes, change in government regulation and/or tax policies (Gujarati and Porter, 2009). As can be seen in Table 6, model 4, model 5, and model 6 are extension of earlier models by adding year dummies as an additional independent variable. The results are robust as all variables have similar findings as the analysis without year dummy. The all year dummies are positively significant with audit committee compliance index total (ACCIT) that indicates that longer period of implementation might lead better compliance with audit committee rules. Meanwhile, all control variables present similar findings to that of analysis without year dummy.

### 4.3.3. Endogeneity

Some researchers in accounting have discussed the importance of paying attention to the endogeneity issue (e.g. Chenhall and Moers, 2007; Larker and Rusticus, 2007; Van Lent, 2007; Wintoki *et al.*, 2012). We focused on dynamic endogeneity because the dynamic endogeneity has been demonstrated by some prior studies in corporate governance-performance relation (see Wintoki *et al.*, 2012; Da Silveira *et al.*, 2010; Schultz *et al.*, 2010). Following Da Silveira *et al.* (2010), in this study, the potential endogeneity problem on determinants of public listed companies' compliance with audit committee rules is tested using the GMM-System (Arellano and Bover, 1995). We assumed that the level of compliance with audit committee rules in the preceding period will affect the compliance level in the current period. In addition, the GMM-System is also robust to deal with all forms of endogeneity such as dynamic endogeneity, simultaneity, and unobservable heterogeneity (Schultz *et al.*, 2010). In the GMM-System model analysis, all models were added with lag of audit committee compliance index (ACCIT<sub>t-1</sub>) as regressors. All regressors were assumed endogenous and instrumented using their lags. The lagged variable is assumed to be predetermined variable as their value is not determined in current time period and is not correlated with error term (Gujarati and Porter, 2009). This study used one lag period for dynamic completeness as the total period of this study is only three periods. However, the results of the DWH test for all models indicated that the null hypothesis could not be rejected as *p-value* is higher than 0.05. It means that regressors in each model are exogenous. Therefore, the study assumes that the OLS model is more appropriate than GMM-system model because the OLS model will produce parameter estimates that are more efficient than those of GMM-

system. As can be seen in model 6, model 8, and model 9, as expected, lag of audit committee compliance index total (ACCIT<sub>t-1</sub>) has positive significant association with audit committee compliance index total (ACCIT). It means that level of audit committee compliance in preceding period positively affects current audit committee compliance.

## 5. Conclusion

The objective of this research is to examine the association between specific Indonesian business characteristics and the public listed companies' compliance with audit committee rules. In general, this study provides empirical evidence that adoption of audit committee by public listed companies and also its effectiveness are influenced by other corporate governance mechanisms. It means that audit committee as one mechanism of corporate governance is not isolated or independent from other mechanisms and this is consistent with the view espoused in the bundle of corporate governance theory (Jensen, 1993; David and Useem, 2002; Filatotchev, 2007; Ward *et al.*, 2009). In a weak legal enforcement regime, even though compliance with audit committee is mandatory, the public listed companies might consider the effectiveness and efficiency of their bundle of corporate governance practices in complying with the audit committee rules. Briefly, the findings support Aguilera *et al.* (2008) argument that there is no one best way to achieve effectiveness of corporate governance and the governance arrangements are varied across firm and their environment.

The research findings provide useful inputs for regulators in Indonesia with respect to enhancing audit committee effectiveness in Indonesia. First, we suggest that the BAPEPAM-LK consider the introduction of a flexible approach in implementing audit committee rules. This suggestion is in line with that advocated by Aguilera *et al.* (2011) urging policy makers to introduce flexibility in the corporate governance system, thus allowing companies to adapt governance practices to their contingencies, but with clear enforcement mechanism to guarantee the desired outcomes. The flexible approach for the audit committee rules may be considered by allowing the public listed companies to comply with some requirements in job duties of audit committee, which are deemed relevant by the companies. Second, it is recommended that the BAPEPAM-LK sets requirements for disclosure of ultimate shareholders of foreign institutional investors or listed companies, which is also advocated by the World Bank (2010). Third, if the public listed companies have only one independent commissioner, the BAPEPAM-LK needs to urge the company to appoint perhaps person who has more balanced ability between financial expertise and wide relationship with external parties rather than solely politically-connected persons.

As is common with all research studies, this research has a few limitations. First, we focus is on examining the immediate period of audit committee reforms because of the lack of complete data of the period before audit committee reforms (before 2006). In fact, panel data is useful to evaluate the effect of certain policy by examining two periods: before and after of the policy (Gujarati and Porter, 2009). Second, we employed quantitative research approach in this study. In fact, some interesting findings in this study might need further clarification by using qualitative approach. For example, future study might further explore how the family affect the audit committee effectiveness using qualitative approach such as field studies (interviews).

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