

INTERNAL GOVERNANCE MONITORING AND EARNINGS QUALITY

RUSMIN

Fakultas Bisnis dan Teknologi Informasi
Universitas Teknologi Yogyakarta

Abstract: This study examines the earnings quality of the Indonesian manufacturing listed firms for years 2003 to 2009. Statistical analysis reveals that size of board and board commissioner independence help predict the quality of financial information. A large number of board commissioner members relates with higher earnings quality. Moreover, the presence of the independent board of commissioners associates with higher financial reporting quality. Interestingly, audit committee attributes especially percentage of independent members on the audit committee and number of audit committee member are not significant predictors. This has significant implications for Indonesian companies since globally companies are moving towards a more regimented corporate governance structure to enhance firm performance.

Keywords: Earnings quality, internal governance monitoring, Indonesia

INTRODUCTION

This paper focuses on internal governance monitoring mechanisms, especially the potential impact of board of commissioner¹ and audit committee effectiveness on the quality of financial reporting. Earnings quality is an issue of growing international importance to investors, policy makers, market analysts

¹ Indonesian firms adapt a two-tier system in their board structure, supervisory board and management board. The supervisory board is called board of commissioners while the management board is called board of directors.

and the general public. For their part, policy makers have sought to introduce various corporate governance reforms designed to aid in the constraint of earnings manipulation. In addition, scholars have not been apathetic. Healy and Wahlen (1999), for example, in a review of the earnings quality literature, called for greater research of factors that limit earnings manipulation.

Some researchers (e.g., Morck, Shleifer, and Vishny 1988; Fan and Wong 2002; Wang 2006; Dechow, Sloan, and Sweeney 1996) suggest that the nature of a corporation's governance structure, specifically board of commissioner and audit committee characteristics enable to provide an effective monitoring mechanism on management activities. Consequently, they are jointly able to oversee the company's financial reporting process. This study, in response to both the growing concern toward earnings quality and calls for more empirical research, investigates the relationship of internal governance monitoring mechanisms with the quality of financial information. Consistent with previous research (e.g., Francis, LaFond, Olsson, and Shipper 2004; Velury and Jenkins 2006; Ball and Shivakumar 2008; Tong and Miao 2011), this study uses earnings predictability and accrual quality to proxy quality of financial reporting while board of commissioner and audit committee characteristics as measures for internal monitoring mechanisms (e.g., Dechow et al. 1996; Beasley 1996; Bedard, Chtourou, and Courteau 2004).

This study differs from prior research on at least two main fronts. Firstly, it provides further evidence on the relation between internal monitoring mechanisms and the level of financial reporting quality using data from unique and different domestic settings, Indonesia. Secondly, I enrich the literature by analyzing the joint relationship between several monitoring mechanisms (number of board commissioner and audit committee members and independent board of commissioner and audit committee) attributes, and earnings quality. As Vafeas and Theodorou (1998) remark, the study of key related corporate governance characteristics in isolation may hide key inferences, leading to misleading findings.

The remainder of the paper is organized as follows. In section 2 a review of the relevant literature is provided. Research methodology including sample selection, data sources, variable measurement and model specification is presented in section 3. The results of this study are discussed in section 4 followed by a brief conclusion in section 5.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

The majority of the literature seeking to explain the incentives to manage earnings draws on costly contracting theory. This study utilizes costly contracting theory which is characterized the corporation as a ‘legal nexus of contractual relationship’ and assumes that corporate reporting enables principals (shareholders) to monitor agents (managers) compliance with contractual obligations (Godfrey, Hodgson, and Holmes 2003). Jensen & Meckling (1976) identify the existence of two agency relationships: (1) the manager-shareholders (e.g, bonus plans) which the manager acts as an agent for the shareholders who are considered to be the owners; (2) the shareholder-debtholder (e.g., debt contracts) where the manager is assumed to act on behalf of the shareholders, thus the manager is an agent whereas the debtholder becomes the principal. Such situations impose agency costs, due to the existence of conflicts of interest between the agents and the principals. Bartov, Gul & Tsui (2001) note that agency costs include manager’s incentive to manage earnings. Empirical evidence from agency theory also reports that management have a preference to manage earnings numbers in order to benefit from the contracting process (Holthausen, Larcker, and Sloan 1995).

Prior studies document that the higher transaction costs are translated from the greater information asymmetry among market participants. When the markets or investors have less information and cannot observe a company’s performance and prospects, they then require higher rates of return and lower current company’s stock prices (Bartov and Bodnar 1996). Several studies also document evidence that the existence of information asymmetry between managers and shareholders is a necessary condition for earnings manipulation (Dye 1988). This is because shareholders have less information, thus corporate management can use its insider position to manage reported earnings (Lobo and Zhou 2001). Earnings manipulation reduces the reliability of earnings because reported earnings is biased, and misrepresents the true reporting earnings figure. Arthur Levitts, Jr., (1998) the former chairman of SEC, states that practice of earnings manipulation has negative effects on reliability and credibility of financial reporting.

Governance Monitoring Mechanisms and Earnings Quality

The role of governance in overseeing management has been the topic of active debate among regulators, corporate governance reformists and academics in recent times due to recent high profile accounting scandals or earnings manage-

ment cases. Cadbury (1997) suggests that strong governance occurs if there is balancing between reporting firm performance with an appropriate level of monitoring. It is argued that corporate governance structures are likely to influence the level of earnings management (e.g., Jensen 1993; Firth, Fung, and Rui 2007; Dalton, Johnson, and Ellstrand 1999; Klein 2002; Xie, Davidson III, and DaDalt 2003).

Board of commissioner characteristics and earnings quality

The board of commissioners is intended to perform critical functions of monitoring and advising corporate management. It is perceived that the number of members on the board affects the board's ability to function effectively. Dalton, Daily, Johnson and Ellstrand (1998) argue that the larger the boards the better the performance because larger boards potentially bring more experience and knowledge as well as offer better advice. However, Huther (1997) suggests that, as any other decision making bodies, governing boards face coordination problems. These problems increase as the size of governing bodies increase. Consequently, Lipton and Lorch (1992) and Jensen (1993) suggest that larger boards are less likely to be effective than smaller boards because of coordination problems and director free-riding. They further argue that the size less than eight is optimal as a smaller board works better and could be less manipulated by the delegated director. Yermack (1996) and Eisenberg et al. (1998), additionally, support the notion that smaller boards are better boards. Especially, they document a negative association between board size and firm's performance, as measured by Tobin's Q.

Goodstein, Gautam and Boeker (2007) argue that different number of board members is needed in different functions. Goodstein et al. (2007) and Zahra and Pearce (2007) suggest that smaller boards, between four to six members, might be more effective in performing advising function, while larger boards is needed in monitoring management activities. Some studies (e.g., Xie et al. 2003; Gong, Firth, and Cullinane 2006) report that having a larger board is associated with higher earnings quality (lower abnormal accruals, proxy for earnings management). Thus, my first hypothesis is:

H₁: There is a positive relationship between the number of members on board of commissioners and the level of earnings quality.

Recently, the quality of board oversight has received increasing attention. Beasley (1996) and Dechow, Sloan and Sweeney (1996) suggest that the ability of the boards to act as an effective monitoring mechanism depends on their independence from management. The boards are considered to be

independence if they do not have any relationship with the company beyond the role of director. Lipton and Lorsch (1992) define an independent director as a director who has no connection with the company, either as management, customer or supplier of goods or services. Thus, the independent board refers to a non-executive director who is not employed by the company and entirely independent from management. The non-executive directors are more likely to have incentives to guard shareholder interests well as they have invested their reputation in a firm (Vafeas and Theodorou 1998; Fama and Jensen 1983).

A number of previous studies report a positive association between board independence and actions that are in the best of interest of shareholders. For example, Beasley (1996) finds that the existence of independent directors associates with less financial statement fraud. Using a sample of U.S. and China firms, Klien (2002) and Firth et al. (2007) respectively reports a negative relation between board independence and the magnitude of earnings management (a proxy for earnings quality). Peasnell, Pope and Young (2000) show evidence supporting Klein's and Firth *et al.* findings in U.K. context. In addition, Dechow et al. (1996) reveal that the more proportion of independent directors the less likely the firm is subjected to Securities and Exchange Commission (SEC) enforcement actions because of violating U.S. GAAP. Consequently, the second hypothesis is:

H₂: There is a positive relationship between the proportion of independent board of commissioners and the level of earnings quality.

Audit committee characteristics and earnings quality

Majority of previous studies concerning the relationship between board of directors' composition and firm value has concentrated on the role of the board at large; however, a great deal of board's decision-making occurs at the committee level. To oversee the accounting and financial reporting processes of a company as well as the audit of its financial statements, board of commissioners delegate their responsibility to an audit committee. Thus, it is expected that this committee provides shareholders with the greatest protection in maintaining the credibility of a company's financial statements (Bradbury 1990). A study of 142 U.K. firms conducted by Collier (1993) suggests that firms establish audit committee to alleviate their agency problem and reduce an information asymmetry between insiders and outsider. Evidence also shows that the formation of audit committee associates with more informativeness of reported earnings (Mitra, Hossain, and Deis 2007) and less financial fraud (McMullen and Raghunandan 1996; Dechow et al. 1996).

Empirical studies provide inconclusive evidence of the impact of audit committee size on financial reporting quality. Abbott, Parker and Peters (2004) and Xie et al. (2003) find no significant association between the number of directors on the audit committee and earnings quality measures. Nonetheless, Yang and Krishnan (2005) reveal that earnings quality is negatively related to the size of the audit committee.

In addition, as suggested above that smaller boards may be more effective (e.g., Yermarck 1996; Eisenberg et al. 1998; Jensen 1993). This is because of larger boards are characterized by slower decision making (Goodstein, Gautam and Boeker 1994), or less cohesive (Lipton and Lorsch 1992), or are more easily manipulated by management (Alexander, Fennell and Halpern 1993). As a result, a smaller number of boards would be beneficial. This study's sample indicates that more than 74% of the firms have audit committees of three or fewer members. Given that the mean of audit committee size in the sample is not so large (which is 2.70) and consistent with Lipton and Lorch (1992) and Jensen (1993) who argue that the maximum size of boards is eight, I expect a positive relationship between audit committee size and financial reporting quality. Thus, my third hypothesis is:

H₃: There is a positive relationship between the number of members on audit committee and the level of earnings quality.

Prior literature indicates that the effectiveness of an audit committee is dependent on its objectivity or independence (Bedard et al. 2004; Davidson, Goodwin-Stewart, and Kent 2005). Lynn (1996) argues that it is impossible for the audit committee to function effectively if they are also members of executives of the firm. Thus, an audit committee should comprise entirely of non-executive or independent directors (Menon and Williams 1994; Lipton and Lorch 1992). This argument is supported by Jiambalvo (1996) who finds that audit committee independence is associated with a higher degree of active oversight and a lower incidence of financial statements fraud. This leads to my fourth hypothesis:

H₄: There is a positive relationship between the proportion of independent audit committee and the level of earnings quality.

RESEARCH APPROACH

Sample

To ensure data homogeneity, this study focuses solely on manufacturing companies identified by the Indonesian Capital Market Directory (ICMD). Another reason to choose manufacturing firms is that these kinds of firms

are dominant in Asia and Indonesia. As Dhawan, Mangaleswaran, Padhi, Sankhe, Schwan and Paresh (2000, , p. 42) noted: “Asia has become the workshop of the world: more than half of all manufacturing on Earth is estimated to take place there.” Within the Indonesian context, Craig and Diga (Craig and Diga 1998, , p. 248) noted that “Indonesia was represented strongly by manufacturing-type entities.”

The sample examined in this study comprises all manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the longitudinal period 2003 to 2009. There are a total of 166 manufacturing firms listed on the IDX. However, I am unable to collect sufficient information to construct a full set of proxy measures for 70 entities; therefore, it is left with a final usable sample of 96 firms or 672 firm-years.

Estimation of Variables

This study examines the earnings quality of manufacturing firms listed in IDX for the fiscal years 2003 to 2009 using the internal governance monitoring mechanisms as the prime predictors. Following previous studies (e.g., Schipper and Vincent 2003; Ball and Shivakumar 2008; Velury and Jenkins 2006; Francis et al. 2004; Tong and Miao 2011) earnings quality is measured using two separate proxies: earnings predictability and accrual quality.

Predictability captures the notion that earnings are of higher quality the more useful they are to predict future earnings. Predictability is viewed as a desirable attribute of earnings because it increases the precision of earnings forecasts. Based on Lipe (1990) earnings predictability is estimated by the R^2 of the error variance from a regression of current earnings on lagged earnings ($NIBE_{i,t} = \alpha + \beta NIBE_{i,t-1} + \varepsilon_{i,t}$).

Where: *NIBE* is firm *i*'s net income before extraordinary items in year *t* divided by total assets at the beginning of period *t*.

Large (small) values of predictability infer less (more) predictable earnings. The measure of accrual quality is based on Dechow and Dichev's (2002) model. It is defined as the standard deviation of the residuals of the following regression of total current accruals to lagged, current and future cash flows from operations:

$$TAC_{i,t} = \alpha + \beta_1 CFO_{i,t-1} + \beta_2 CFO_{i,t} + \beta_3 CFO_{i,t+1} + \varepsilon_{i,t}$$

Where: *TAC* is firm *i*'s total current accruals in year *t*, *CFO* is firm *i*'s cash flow from operations in year *t*. All variables are divided by total assets at the beginning of period *t*.

Large (small) value of accrual quality relates to poor (good) earnings quality.

This study employs four internal governance monitoring mechanisms (number of board of commissioner and audit committee members and the independent of the board of commissioner and audit committee) to predict the quality of financial reporting. The study measures board of commissioner or audit committee size by the total number of members on the board or audit committee. While, board of commissioner or audit committee independence are proxied as percentage of the board of commissioners (audit committee) that is independent (Klein 1998, 2002; Han and Wang 1998; Bedard et al. 2004; Davidson et al. 2005).

To control for compounding influences of cross-sectional factors, this study includes control variables in the regression analysis. Consistent with Becker et al. (1998); Francis, Reichelt & Wang (2005); and Davidson et al. (2005), this study includes firm's size (*Size*) as prior studies indicated that litigation risk is greater for larger clients than for smaller size clients (Lys and Watts 1994; Heninger 2001). The perceived quality of the auditor is also considered to be a possible determinant of the magnitude of earnings management (e.g., Frankel, Johnson, and Nelson 2002; Gul, Chen, and Tsui 2003). Prior research usually distinguishes between non Big-4 and Big-4 audit firms arguing the latter to be of a higher quality than the former (Heninger 2001; Mayhew and Wilkins 2003). This study includes *Big-4* as a control for perceived auditor quality. *Leverage* is included as prior studies show that firms with a higher likelihood of violating debt agreements are more likely to have an incentive to engage in earnings management to increase earnings (e.g., Press and Weintrop 1990; DeFond and Jiambalvo 1994; Sweeney 1994; Healy and Palepu 1990). According to Roberts (1992), firms that more mature in term of age seem to disclose more voluntary information since they generally gain more reputation, thus, the firm's age (*AgeFounded*) is included. Finally, previous studies (e.g., Dechow, Sloan, and Sweeney 1995; Kothari, Leone, and Wasley 2002) report earnings quality are dependent on a firm's financial performance. Furthermore, financial performance may influence a firm's audit risk (e.g., Gul et al. 2003; Krishnan 2003). Accordingly, return on assets (*ROA*) is used to provide control for the possible compounding influences of a firm's financial performance. Proxy measures for the dependent, independent and control variables are defined in Table 1.

Table 1 Variable Definition and Description

Variable Description	Variable Title
<i>Dependent Variables</i>	
Earnings predictability measure computed based on Lipe (1990) model	<i>Predictability</i>
Accrual quality measure computed based on Dechow and Dichev's (2002) model	<i>AccQuality</i>
<i>Control Variables</i>	
Natural logarithm of the total sales of firm <i>i</i> for their fiscal year <i>t</i>	<i>Size</i>
Indicator variable with firm <i>i</i> scored one (1) if their auditor in fiscal year <i>t</i> is a Big-4 firm; otherwise scored zero (0)	<i>Auditor</i>
Ratio of book value long-term debt of firm <i>i</i> for year <i>t</i> to book value total assets of firm <i>i</i> for year <i>t</i>	<i>Leverage</i>
Number of years since firm <i>i</i> is founded to year 2009	<i>AgeFounded</i>
Ratio of net profits of firm <i>i</i> for year <i>t</i> to book value total assets of firm <i>i</i> for year <i>t</i>	<i>ROA</i>
<i>Independent Variables</i>	
Total number of board of commissioner members	<i>BOC</i>
Percentage of the board of directors that is independent	<i>IndBOC</i>
Total number of audit committee members	<i>AudCom</i>
Percentage of the audit committee that is independent	<i>IndAudCom</i>

Empirical Model Equations

This study uses OLS multiple regression as the main statistical technique to test the hypotheses. The main regression model is defined in the following equation:

$$EarningsQuality_i = \alpha + \beta_1 BOC + \beta_2 IndBOC + \beta_3 AudCom + \beta_4 IndAudCom + \beta_5 Size + \beta_6 Big4 + \beta_7 ROA + \beta_8 Leverage + \beta_9 AgeFounded + \varepsilon_i$$

DESCRIPTIVE AND STATISTICAL ANALYSES

Table 2, Panels A and B, provides the descriptive statistics for the dependent, independent and control variables. Panel A shows the descriptive statistics for the continuous variables in the regression model. Panel B reports details of the dummy regression variables.

Table 2 Descriptive Statistics

<i>Panel A – Continuous variables</i>					
	<i>Mean</i>	<i>Median</i>	<i>Std Dev</i>	<i>Minimum</i>	<i>Maximum</i>
<i>Earnings Predictability</i>	0.2929	0.2363	0.3119	0.0001	1.8634
<i>Accrual Quality</i>	-0.0019	-0.0012	0.0685	-0.1625	0.1882
<i>IndBOC (%)</i>	39.35	33.33	11.09	0	80.00
<i>IndAudCom (%)</i>	23.78	33.33	16.31	0	66.67
<i>BOC</i>	4.03	3.40	1.65	2.00	10.40
<i>AudCom</i>	2.70	3.00	0.79	0.00	4.00
<i>ROA (%)</i>	3.97	3.45	8.97	-21.42	37.27
<i>Leverage (%)</i>	68.00	58.38	61.35	10.91	152.99
<i>Sales (million IDR)</i>	2,031,443	503.960	4,750,877	96	25,636,995
<i>AgeFounded</i>	36.17	32.67	22.08	7.76	108.97

<i>Panel B – Dummy regression variables</i>			
<i>Auditor Type</i>		<i>Frequency</i>	<i>Percentage</i>
<i>Non Big 4</i>		41	42.71
<i>Big 4</i>		55	57.29

Legend: See Table 1 for full definitions and descriptions for the dependent, independent and control variables.

Table 1, Panel A indicates that average earnings predictability is 0.2929 (ranging from 0.0001 to 1.8634). Accrual quality measure has a mean (median) value of -0.0019 (-0.0012) and a standard deviation of 0.0685. In regard to independent variables, the percentage of independent commissioner has an average of 39.35% with a median of 33.33%. On average, only 23.78% of audit committee members are independence. This is consistent with many other developing countries that the percentage of independent commissioners and independent members of the audit committee are under 50%. In addition, the sample firms have, on average, 4 and 3 members sitting on the board of commissioners and audit committee respectively.

Size of the companies that are included in the sample has a wide range. Panel A shows that the size of the Indonesian companies has a mean of IDR2,031,443 million, ranging from IDR96 to IDR25,636,995 million. Average total liabilities to total assets ratio (*Leverage*) of the sample firms is 68.00%, demonstrating that Indonesian companies are heavily financed by third party funds rather than self-financing. On the other hand, most of the

sample firms earn relatively lower profits during 2003 to 2009 financial years. As presented in Panel A, the sample firms' net profit to total assets, on average, is 3.97% ranging from losses 21.42% to profit 37.27%. Indonesian firms on average are 36 years old. Finally, the Big-4 accounting firms audit more than half the Indonesian manufacturing listed firms.

The correlations of the variables are presented in Table 3. The Pearson correlation coefficients provide some evidence of the direction of the results. All of the internal governance monitoring variables is negatively correlated with *Accrual Quality*. These negative coefficients imply that these board commissioners and audit committee characteristics are associated with higher earnings quality. Consistent with predictions, independent board of commissioners (*IndBOC*) is negatively associated with *Earnings Predictability*, inferring that independent commissioner members act as an effective monitoring mechanism in overseeing the financial reporting process thus higher earnings quality. However, those relationships are statistically not significant.

In addition, there is a significant correlation between the two independent variables (*AudCom* and *IndAudcom*) with a coefficient of 0.535 ($p < 0.001$), however this is below the critical limit of 0.80 (Hair, Anderson, Tatham, and Black 1995; Greene 1999; Cooper and Schindler 2003). In respect to correlations between independent and control variables, and amongst control variables themselves, the highest correlations are between *Leverage* and *ROA* with a coefficient of 0.235 ($p < 0.05$). This value is, far below the critical limit of 0.80. Variance inflation factors calculated for the regression reported in Table 4 for all independent and control variables provide further indications that multicollinearity is not a problem in the model estimations (Hair et al. 1995; Greene 1999; Cooper and Schindler 2003).

Table 3 Pearson Correlation Matrix

	Earnings Predictability	Accrual Quality	BOC	Aud Com	Ind BOC	Ind AudCom	Auditor	ROA	Leverage	Size	Age Founded
Earnings Predictability		0.352*	0.154	0.038	-0.023	0.056	0.252**	0.502*	-0.152	0.109	0.265*
Accrual Quality			-0.148	-0.053	-0.020	-0.001	0.109	0.633*	-0.259**	0.020	0.062
BOC				0.125	0.045	0.111	0.104	0.043	-0.006	0.130	0.196
AudCom					0.150	0.535*	0.042	0.056	-0.054	-0.090	0.116
IndBoc						0.086	-0.009	0.228**	0.065	0.048	0.141
IndAudCom							0.065	0.081	-0.195***	0.069	0.234**
Auditor								0.282*	-0.087	0.089	0.176
ROA									-0.235**	0.201**	0.228**
Leverage										-0.059	0.039
Size											0.016

Legend: *, ** and *** indicate significance at $p < 0.01$, $p < 0.05$ and $p < 0.10$ (based on two-tailed tests).

See Table 1 for full definitions and descriptions for the dependent, independent and control variables.

The main result for testing the impact of corporate governance monitoring mechanisms on earnings quality is reported in Table 4.

Table 4 Multiple Regression Results

	Panel A—Earnings Predictability		Panel B—Accrual Quality	
	Beta	t-statistic	Beta	t-statistic
(Constant)		1.743***		1.437
<i>BOC</i>	-0.028	-1.640***	-0.007	-2.054**
<i>IndBOC</i>	-0.311	-1.215	-0.093	-1.865***
<i>AudCom</i>	-0.012	-0.299	0.008	0.966
<i>IndAudCom</i>	-0.001	-0.007	-0.034	-0.843
<i>Auditor</i>	-0.043	-0.748	0.012	1.112
<i>ROA</i>	1.896	5.502*	0.497	7.374*
<i>Leverage</i>	-0.022	-0.469	-0.012	-1.266
<i>Size</i>	-0.030	-2.584*	-0.002	-1.021
<i>AgeFounded</i>	0.093	1.571	-0.005	-0.407
Model Summary				
R-Squared	0.357		0.490	
Adj. R-Squared	0.289		0.437	
F-Statistic	5.296*		9.187*	
Sample Size	96		96	

Legend:

*, **, and *** indicate significance at $p < 0.01$, $p < 0.05$ and $p < 0.10$, respectively (based on two-tailed tests). See Table 1 for full definitions and descriptions for the dependent, independent and control variables.

Panels A and B present the results of regression using earnings predictability and accrual quality respectively. Regression model estimates reported in Table 4, Panels A and B are all statistically significant (F-statistic $p < 0.001$) with explanatory power of 29% (Panel A) and 44% (Panel B). The coefficients on *BOC* are negative and statistically significant in both earnings quality measurements (at $p < 0.10$ and $p < 0.05$ respectively). Thus, the evidence support the notion that larger number of board commissioner members associates with higher quality of financial information and therefore, H_1 is accepted. This finding is consistent with previous studies, for example Dalton et al. (1998), Xie et al. (2003) and Gong et al. (2006) who document that the larger the boards the better the performance because larger boards potentially bring more experience and knowledge as well as offer better advice.

However, this finding is inconsistent with Lipton and Lorch (1992) and Jensen (1993) who suggest that larger boards are less likely to be effective than smaller boards because of coordination problems and director free-riding.

In regard to board of commissioners independence, as predicted, this study finds that the coefficients on *IndBOC* is negative and significant (at the bottom level of $p < 0.10$) associated with *Accrual Quality* (but it is insignificant for *Earnings Predictability*). Thus, H_2 is partially accepted. This implies that independent members of board commissioner do act in the best of interest of shareholders. They act as an effective monitoring mechanism to oversee the accounting and financial reporting processes of a company. Thus, this finding support previous studies (e.g., Klein 2002; Peasnell et al. 2000; Firth et al. 2007). Finally, this study fails to support the argument that audit committee provides shareholders with the greatest protection in maintaining the credibility of a company's financial statements. The coefficients on *AudCom* and *IndAudCom* are negative associated with, especially *Earnings Predictability*, but it is statistically insignificant. Therefore, both H_3 and H_4 are rejected.

IMPLICATIONS AND CONCLUSION

The results of this study partially support the empirical validity of the claims that the four internal governance monitoring mechanisms (board of commissioners and audit committee size, and board and audit committee independence) influence the quality of financial reporting. As expected, the findings show a negative association between the two measures for earnings quality (*Earnings Predictability* and *Accrual Quality*) and *BOC*. In line with Dalton et al. (1998), Xie et al. (2003) and Gong et al. (2006), this evidence suggests that larger member of boards of commissioners is associated with higher earnings quality. The results of this study, however, contradict to the conclusion reported by Yermack (1996) and Eisenberg et al. (1998).

This study also finds that board of commissioner independence is negatively and significantly associated with *Accrual Quality*. It infers that the presence of independent board of commissioners provides a greater incentive to monitor management activities reduces agency costs, thus, enhances earnings quality. In other words, companies with more independent board of commissioners have better performance than their counterpart.

This study indicates that no significant relationship between both number of audit committee member and independent of audit committee and the quality of financial reporting of Indonesian manufacturing listed firms. The results

fail to confirm Jiambalvo (1996), Yang and Krishnan (2005) and Mitra et al. (2007) who argument that more audit committee member and or greater use of audit committee independence can lead to more effective internal monitoring.

The findings of this study have implication, especially, to regulators and corporate governance reformists. Special attentions need to be given by Indonesian policy makers in strengthening corporate governance framework; primarily, in regard to: (1) the process for monitoring and selection of independent board of commissioners and audit committee, (2) enhance the skills and knowledge of the independent boards and audit committee members, and (3) separation of management from the owners and appointment of professional managers.

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