ISSN: 0853-1259
JURNAL AKUNTANSI & MANAJEMEN
Tahun 1990

Vol. 24, No. 2, Agustus 2013
Hal. 83-94

CORPORATE GOVERNANCE AND ACCOUNTING REFORM IN EMERGING ECONOMIES: THE CASE OF INDONESIAN LISTED COMPANIES

Theresia Trisanti
Sekolah Tinggi Ilmu Ekonomi YKPN Yogyakarta
Jalan Seturan Yogyakarta 55281
Telepon +62 274 486160, 486321, Fax. +62 274 486155
E-mail: thtrisanti@yahoo.com

ABSTRACT

The primary objective of this study is to answer the question whether the introduction of corporate governance (CG) codes and the convergence accounting standards to International Financial Reporting Standards (IFRS) has significant impact on the income smoothing (IS) practices among Indonesian listed firms. Answering this questions was a great concern to all market participants because the high occurring of IS practices within Indonesian listed firms were high (56%). Moreover, CG codes and IFRS were developed from countries that have different context and conditions with Indonesia. The paired t-test for comparing two means was used to know the effect of the introduction of CG codes and the convergence accounting standards to IFRS. For investigate the factors associated with income smoothing, the logistic analysis was used in a multivariate setting. Research concluded, there was a significant difference of IS practices after the introduction CG codes and after the convergence accounting standards to IFRS compared to its prior period respectively.

Keywords: income smoothing practices, corporate governance, IFRS

JEL classification: O16, G34

INTRODUCTION

Business investment through capital markets is the main driver of economic growth in many countries. Indeed, capital market plays a crucial role in rising capital, promoting balance and stability in the financial system, driving the national economy and creating jobs. There are many factors involved in maintaining the growth of capital market but the financial report quality of listed companies are the most important factors as they have been the research focus from different perspectives. However, the overall conditions of financial report quality among Indonesian listed companies are still considered poor. A McKinsey investor opinion survey (2006) and World Bank Survey (2004) noted that Indonesia had the lowest perceived of financial report quality among four ASEAN countries (Singapore, Malaysia, Thailand and Philippines). There are many factors involved on the poor of financial report quality by Indonesian listed firms, one of them because of the high of IS practices (Susanti, 2008). The IS practices happen when a company's management takes steps to reduce and store earnings during the good years and defer them for use during the business-downturn years or vice versa (Kang & Kim, 2011; Chong, 2008). Recent accounting research on IS practice reveals that comparison to their developed-country counterparts, IS practices in developing and emerg-

ing economies are higher (Bhattacharya, *et al.*, 2004). As an emerging market, Indonesia has a very high occurrence of IS practices since around 56% of Indonesian listed firms committed such practices (Susanti, 2008). The IS practices will not only result in fictitious information in financial reports but in the long term they could also lead to other complex manipulation to meet the increasing internal sales target and external stakeholders' expectation.

To effectively constrain the IS practices which eventually will improve the FRQ, attentions should be given to two important factors influencing financial reporting: the accounting standards used in prepare the financial reports and the corporate governance mechanisms. First, good accounting standards can limit the opportunistic discretion and may result in accounting earnings that are more reflective of a company's underlying economics and, therefore, are of higher quality (Jeanjean & Stolowy, 2008). It is expected that accounting amounts determined by the IFRS are of higher quality than those determined in domestic generally adopted accounting principles (Elena *et al.,* 2011; Mc Anally *et al.,* 2011).

Second, CG Codes plays an important role in monitoring and evaluating management and assessing whether directors acted responsibly when corporations fail. CG Codes acts to align the interests of shareholders and management over long periods in complex organizations. It aims to ensure that management will exert maximum effort on behalf of shareholders, and will not misappropriate resources via excessive abuse of authority (Bauwhede & Willekens, 2003). After the financial crisis in 1998, the Indonesian government had initiated many efforts to improve the FRQ of the listed companies. These efforts can be grouped into these following major events: Firstly, in 2000 introduced the National Code of Corporate Governance and listing requirements of the Jakarta Stock Exchange (IDX, 2002). Secondly, in 2005 the converged the Indonesian accounting standards to IFRS. Therefore, the main objective of this study is to examine the IS practices in three different periods and to identify factors contributing to this practices in Indonesian public listed companies. Accordingly, there are two specific research objectives as follows 1) To investigate the effect of CG reforms and accounting standard reforms on IS practice by Indonesian listed firms in the period from 1995 to 2009 and to ascertain whether the IS practices have become less or still remain the same or similar and 2) To investigate the effects of selected Indonesian listed company corporate governance attributes (the independent boards and independent audit committee) and external audit quality to the IS practices.

MATERIALS AND METHODS

Many theories have been applied to understand why income smoothing is practiced by many companies despite it is prone to financial fraud. Although theories underlying the concept of income smoothing are still waiting for detailed development (Stolowy & Bartov, 2004), two well-known theories will be presented: Agency Theory and Positive Accounting Theory (PAT). Agency Theory is defined as a relationship by consent between two parties, whereby one party (agent) agrees to act on behalf of the other party (principal). For example, the relationship between shareholders and managers of a corporation is an agency relationship. Agency Theory assumes there is a conflict of interest between the principal (such as the owners of a firm) and the agent (such as the manager). An agency problem arises because the agent may not act in the best interest of the principal and vice versa. Agency Theory could be used to understand the practice of IS that it is a result of conflicting interests between the principal and agents especially on how agents response to the contract of their compensation structure.

Second, PAT refers to theory that attempt to explain and predict accounting practice that will be chosen by managers. PAT focuses on the relationships between the various individuals involved in providing resources to an organization and how accounting is used to assist in the functioning of these relationships. PAT provides some predictions about accounting choices used by managers. Related to income smoothing practices, this prediction will be useful for financial reporting users (e.g. investor, financial analyst, lender, auditors, and standard setters). For example, by using the PAT investors or analysts do not interpret balance sheets and income numbers as unbiased estimates of firm value and changes in firm value. Instead, they recognize the effect of the contracting and political processes on the calculation of income and balance sheet numbers (Collin *et al*., 2009).

Prior studies address the importance of corporate governance in constraining earnings management and IS practices in Korea, Germany, Romania and Taiwan (Kang & Kim, 2011; Liliana *et al.*, 2011) and in emerging markets (Kim & Yi, 2006), as well as studies in Indonesia (Nuryanah, 2011; Siregar & Utama, 2008; Arifin, 2003). These studies provide evidence that the better corporate governance characteristic was associated with lower levels of earnings management or IS practices and therefore will improve the FRQ. Accordingly the hypothesis for this study is stated as follows:

H$_1$: There is significantly difference on IS practice after the adoption of CG Codes compared to the preperiod adoption.

As the rapid growth in international business and the globalization of capital markets, since 2000 there has been a growing movement in countries all over the world to adopt IFRS for listed and cross-listed companies. Starting in 2005 the IAI has had a commitment that Indonesian accounting standards have to gradually converge to IFRS (IAI, 2009). Prior studies have documented that accounting quality has improved after voluntary IFRS adoption (Ball *et al.*, 2003). The proponents contend that the current version of IFRS has reduced allowable accounting alternatives, limited the management's opportunistic discretions, and required accounting measurement and disclosure that can better reflect a company's financial position and economic performance (Leuz *et al.*, 2008; Barth *et al.*, 2008). Therefore, it is hypothesized that after the adoption of IFRS the IS practices will be lesser. Accordingly the hypothesis for this study is stated as follows:

H$_2$: There is a significantly difference on IS practices after the convergence to IFRS compared to the pre-period convergence.

After verifying the two main hypotheses, the next step was to determine the factor affecting income smoothing practices on Indonesia listed companies. Based on the prior research, it is concluded that IS practices might be influenced by some factors. The succeeding sections present the hypotheses on the relationship of three variables to income smoothing practices.

An independent board plays an important role in today's complex organization when the specific interests of executive management and the wider interest of the company may diverge (Machuga & Teitel, 2007; Davidson *et al.,* 2005). Independent non-executive directors are generally considered better in monitoring than other directors because they have the ability to act with a view to the interests of the company (Liliana *et al.*, 2011). However, Brend and Patrick (2011) find that outside directors do not reduce the incident of earnings management. Outside directors may lack the financial sophistication to detect earnings management or sense of ownership to the firm they monitor. As the board size varies, the proportion of independent non-executive directors on the boards would give an indication of the board's relative independence. For this study the proportion of independent board members is calculated from the number of independent commissioners divided by the total number of commissioners on the board. Accordingly, the hypothesis is:

H$_3$: There is a significant relationship between the IS practices and the existence of independent commissioner on the board.

It is generally accepted that audit committees play a significant role in a firm's corporate governance system (Shen & Chih, 2007). Xie *et al*. (2009) and Davidson *et al.* (2005) find that an independent audit committee and active audit committee are associated with lower levels of discretionary accruals. This is because as one of the main roles of the audit committee is to monitor the integrity of the financial reporting of the firm. It is expected that an active, well-functioning and well-structured audit committee will be effective in constraining the managerial behavior on IS practices (Chatterjee, 2011; Krishnan, 2005 & 2003). For this study, the independent audit committee is measured based on the proportion percentage of the independent audit committee, calculated from the number of independent audit committee divided by the total number of audit committee members. Thus, the hypothesis tested in the study can be stated as follows:

H$_4$: There is a significant relationship between the IS practices and the existence of the independent audit committee on the board.

The external audit is intended to enhance the credibility of the financial statements of a firm. External auditors are supposed to verify and certify the quality of financial statements issued by the management (Fan & Wong, 2005). Several studies examine the association between external auditor quality and earnings

management. Research evidence suggests that the large audit firms are perceived to perform a higher audit quality than smaller audit firms (O'Sullivan *et al.*, 2008; Yang *et al*., 2008; and Xie *et al*., 2003). The type of auditors is selected as an explanatory variable in this study to determine whether the magnitude of IS practices is a function of the type of auditors (O'Sullivan *et al*., 2008; Krishnan, 2005).

The types of external auditors are categorized into groups; before 1998 the "Big six" firms (Arthur Andersen, Deloitte and Touche, Peat Marwick Mitchell, Ernst and Young, Cooper and Lybrand, and Price Waterhouse) or after 1998 the "Big four" firms (Deloitte Touche Tohmatsu, KPMG, Ernst & Young, and Price Waterhouse Cooper) and "non- Big-six" firms (other than the big six or big four firm). The "Big six or four", which operate throughout the world with high reputation, are expected to be unlikely involved in and associated with income smoothing practices. On the other hand, the "non-Big-six-or-four" firms are hypothesized to be as less reputable and lower prestige is expected to have more tolerance with their (Fan & Wong, 2005). External auditors' size is used to measure external audit quality, where one for firms audited by Big 6 or 4 auditors (high audit quality) and zero for firms audited by non-Big 6 or 4 auditors (low audit quality). Accordingly, the hypothesis is as follows:

H_5: There is a significant relationship between the IS practices and the quality of external audit firms.

The process to identify which company is practicing IS among all companies listed in IDX was conducted by employing income variability method was used to determine the income smoothing index:

$$\text{Income smoothing index} = (CVi / CVs)$$

Where:

i = one-period change in income

s = one-period change in sales

CVj = coefficient of variation for period j (i.e., j's standard deviation divided by its expected value)

If the Cvi (the coefficient of variation for income) is less than the CVs (the coefficient of variation for sales), the ratio will be less than one, then suggesting that the firm is an income smoother. There were three types of income smoothing objects examined in this study. They were income from operations (IFO), income before extraordinary items (IBE) and net income after tax (NIT). Firms that had average scores of less than one from the three smoothing objects (IFO, IBE, and NIT) were categorized as smoother firms and needed further analysis in the second stage. Accordingly, the non-smoother samples were firms that had average score e" 1 from all three smoothing objects.

For H3 up to H5 of this study, the logistic analysis was used in a multivariate setting to investigate the factors associated with income smoothing. The logistic model is considered appropriate because the dependent variable is nominally measured (dichotomous "0" and "1") and the independent variables are either interval or nominally measured. The logistic regression is a form of regression which is used when the dependent is a dichotomy (of 2 categories) and the independents are of any type. The goal is to find the best set of coefficients so that the cases that belong to a particular category will, when using the equation, have a very high calculated probability that they will be allocated to that category. This enables new cases to be classified with a reasonably high degree of accuracy as well (McClave, 2011). Diagrammatically the logistic regression model above can be described as in Figure 1.

Table 1 presents the final number of firms with complete data (137) for analysis after 19 firms were removed from the initial number of firms. These 19 firms were financial institution, delisted, privatized, or merged during the period of 1995 to 2009.

For each of these 137 firms was then analyzed its income smoothing practice at three different periods. In each period, the Eckel index of a firm was computed for all three smoothing objects (IFO, IBE, NIT). A firm was categorized as a smoother firm if the average of these three Eckel indexes were less than 1. Since each firm was categorized as a smoother and non-smoother exclusively then each was labeled using 1 or 0 respectively. Table 2 lists the number of smoothing and non-smoothing firms for three different periods.

RESULT AND DISCUSSION

The first research objective aims to know the effect of the introduction of CG Codes on IS practice, then the analysis can be carried out by comparing the proportion of smoother firms in two different periods. These

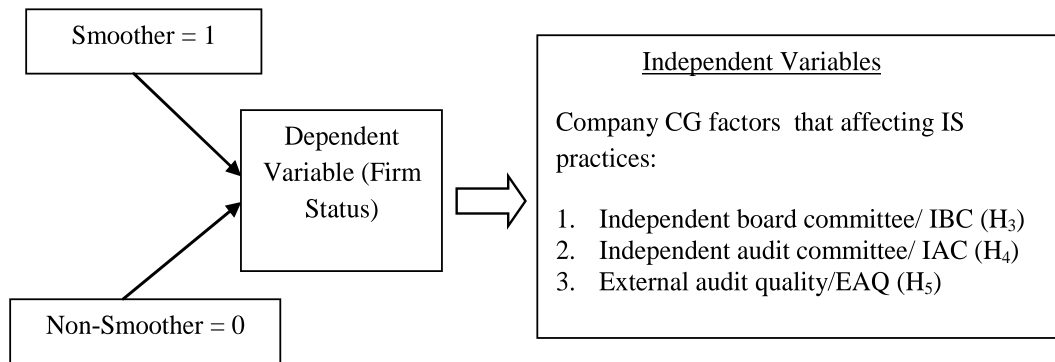

Figure 1
Diagram of the Logistic Regression Test

Table 1
Firms with Complete Financial Data

Description	Number of firms
Listed firms with complete financial report (1995 up to 2009)	156
Financial institution, delisted, privatized or merged firms	(19)
Listed firms with complete data from 1995 up to 2009	137

Source: Research data.

Table 2
The Smoothing and Non-smoothing Firms for Three Different Periods

1995 - 1999		2000 - 2004		2005 – 2009	
Smoother	**Non-Smoother**	**Smoother**	**Non-Smoother**	**Smoother**	**Non-Smoother**
81	56	74	63	68	69
59%	51%	54%	56%	49%	51%

Source: Research data.

periods were before (1995-1999) and after (2000-2004) the introduction of CG Codes. To make sure that the analysis really answer the effect CG Codes to firm IS practices, a paired-sample t-test is employed. It is because each sample was collected from the same firm (each firm gave two values, smoothing or non-smoothing in two different periods). In other words, the paired samples t-test was be used to determine whether two means are different from each other when the two samples are taken from the matched individuals or the same individuals (McClave *at al*., 2011). Table 3 provides the descriptive statistics for each of the two groups before (1995-1999) and after (2000-2004) the introduction of CG Codes, in which there are N= 137 pairs of observations. The column labeled “Mean” is basically the proportion of smoother firms out of 137 firms.

Table 3
Descriptive Sample T Test on Continuous Dependent Variables Before and After Introduction of CG Codes

Description	Mean	N	Std. Deviation	Std. Error Mean
1995-1999	0.74	137	0.442	0.038
2000-2004	0.66	137	0.474	0.040

Source: Research data.

The statistical test to facilitate the hypothesis testing that CG Codes affects significantly to the IS practice is given in Table 4. From this table, the column labeled "mean" is the difference of the two proportion of smoothing firms before and after the introduction of CG Codes. The proportion difference is 0.073 (0.74-0.66) which means that the proportion decrease. Therefore, a paired sample *t* test shows a statistically significant difference between the mean numbers during the financial crisis (1995-1999) (M=0.74, s= 0.442) and after the introduction of CG Codes (2000-2004) with (M=0.66, s= 0.474) of the smoother firms, t (136) =3.272, *p*=0.001, *á*=0.01.

Therefore the result supported the first hypotheses that there is a significant difference on reducing of IS practices after the adoption of CG Codes when compared to the practices in the pre-adoption period. The reason was corporate governance systems establishing transparency and accountability through financial reporting systems and enhance the financial reporting quality. This finding is consistent with the research conducted by Lin (2011) in Taiwan, Adekoya (2011) in Nigeria, Machuga *et al.,* (2007) in Mexico and Yang *et al.,* (2008) in China, who found that listed companies report lower income smoothing practices after introduction of CG Codes.

The second hypothesis of this study is to answer whether firms' IS practices significantly decreased after the Indonesian GAAP converged to IFRS in 2005. Steps used to answer this question were similar to the one for the first hypothesis. The effect of the convergence of IFRS to IS practices was analyzed by comparing the proportion of smoother firms in two different periods. These periods were before the convergence of Indonesian GAAP to IFRS (2000-2004) and after the convergence (2005-2009). Table 5 provides the descriptive statistics for each of the two groups, before convergence of Indonesian GAAP to IFRS (2000-2004) and after (2005-2009), in which there were N= 137 pairs of observations and the column labeled "Mean" is basically the proportion of smoother firms out of 137 firms.

Table 4
Paired Differences Sample Test Before and After Introduction of CG Code

Description	Mean	Std. Deviation	Std. Error Mean	T	df	Sig. (2tailed)
Pair 1995-1999 with 2000-2004	0.073	0.261	0.022	3.272	136	0.001***

Source: Research data.
* Notes: The table indicated significance at 0.01 (***), 0.05(**) and 0.1(*) levels

Table 5
Descriptive Sample T Test on Continuous Dependent Variables Before and After Convergence to IFRS

Description	Mean	N	Std. Deviation	Std. Error Mean
2000-2004	0.66	137	0.474	0.040
2005-2009	0.60	137	0.492	0.042

Source: Research data.

In the Table 6, the column labeled "mean" is the difference of the two proportion of smoothing firms before and after the convergence of Indonesian GAAP to IFRS. The proportion difference is 0.066 (0.66-0.60), which means that the proportion decrease. A paired sample *t* test showed a statistically significant difference between mean number before the convergence (2000-2004) (M=0.66, s= 0.474) and after the convergence to IFRS (2005-2009) with (M=0.60, s= 0.492) of the smoother firms, t (136) =2.546, *p*=0.012, á=0.05.

Therefore, the finding presented in the Table 6 supports the second hypothesis that there is a significant difference of IS practices before and after Indonesian GAAP converged to IFRS. This result reveals the improvement of financial report quality as shown by the reduction of IS practices. The results indicate that the adoption of IFRS reporting leads to significant benefits in terms of increases transparency and limited the management's opportunistic discretions that can better reflect a company's financial reporting. This research finding is in line with the previous research by Lin et al., (2011) in Taiwan, Warsame (2006) and Adekoya (2011) in Africa and Aussenegg et al., (2008) in European listed firms, who found that after IFRS adoption the IS practices reduced significantly and, therefore, improved the FRQ.

Income smoothing behavior was hypothesized to be associated with several factors. For the hypotheses (H3 until H5) are to investigate the association between company specific variables to IS practices. This association was modeled using the logistic regression. Using this model, the dependent variable only contains two categories: the income smoothing status of companies, which 1 is for smoothers and 0 for non-smoothers. Table 7 shows the logistic regression output with the logistic regression model which is as follows:

$$\text{Logit (pi)} = \ln [\text{pi}/1\text{-pi}] = \alpha + \beta_1 \text{ IBCi} + \beta_2 \text{ IACi} + \beta_3 \text{EAQ}$$

From these outputs, the estimated logistic regression equation for the period of after the convergence to IFRS (2005-2009) can be determined as follows:

$$\text{Logit(pi)} = 12.011 + 0.020{*}\text{IBC} + 0.007{*}\text{IAC} - 1.130{*}\text{EAQ}$$

Table 6
Paired Differences Sample Test; Before and After Convergence to IFRS

Description	Mean	Std. Deviation	Std. Error Mean	T	df	Sig. (2tailed)
Pair 2000-2004 with 2005-2009	0.066	0.302	0.026	2.546	136	0.012**

Source: Research data.
* Notes: The table indicated significance at 0.01 (***), 0.05(**) and 0.1(*) levels

Table 7
Logistic Regression Analysis

Variables	After Introduction CG Codes (2000-2004)						After Convergence to IFRS (2005-2009)					
	B	S.E.	Wald	df	Sig.	Exp(B)	B	S.E.	Wald	df	Sig.	Exp(B)
IBC	0.016	0.024	0.046	1	0.504	0.616	0.020	0.026	0.551	1	0.445	1.020
IAC	-0.012	0.026	0.252	1	0.727	0.994	0.007	0.023	0.075	1	0.584	1.007
EAQ	-0.954	0.544	3.080	1	0.080*	0.385	-1.130	0.477	4.347	1	0.040**	0.340
Constant	*9.718*	*2.862*	*10.157*	1	0.013	*16618.1*	*12.011*	*3.927*	*8.775*	1	0.004	*164617*
-2 Log-likelihood Value						282.577						198.783
Omnibus Test (Model Chi square)	86.093 (df=8) (p>0.000)						80.915 (df=8) p>0.000)					
Hosmer & Lemeshow (Goodness of fit test)	7.820 (df=8) (p>0.651)						6.156 (df=8) (p>0.630)					
Cox & Snell R Square						0.562						0.697
Nagelkerke R Square						0.695						0.768

Source: Research data.
Notes: The table indicated significance at 0.01 (***), 0.05(**) and 0.1(*) levels

The result of Table 7 also shows the model Chi-square which tests the joint null hypotheses that all slope coefficients are zero proves to be statistically significant at the 1% level for all three periods. This implies that the eight model's predictors are able to predict the IS practices. The Negelkerke R-square was 0.695 after the introduction of CG Codes (2000-2004), and was 0.768 after the convergence to IFRS (2005 - 2009). It means that on the average the model's predictors could explain 73% in the variation of the smoothing practices. This percentage indicates a moderately strong relationship of 73% between the predictors and the prediction (Nuryanah, 2011).

To test the reliability of the estimated model, the study used the Hosmer and Lemeshow (H-L) goodness-of-fit test in testing the difference between the model's predicted values and the observed values. If the H-L goodness-of-fit test is greater than 0.05, as wanted for well-fitting model, then one fails to reject the null hypothesis that there is no difference between the observed and model-predicted value. This means that well-fitting models show non-significance on the H-L goodness of fit test. With these in mind, the p-value of 0.630 for the period after convergence to IFRS (2005 - 2009), which is computed from the Chi-square distribution with 8 degrees of freedom, is not statistically significant and, therefore, the used model was quite a good fit. The same findings occurred for the period after the introduction of CG Codes 0.651, which means that the used model is quite a good fit respectively.

The Exp(B) value in Table 7 indicates the increase or decrease in predicted probabilities if the corresponding predictor is increased by one unit. If the value of Exp(B) exceeds 1 then the predicted probability of occurrence increases, conversely if Exp(B) value is less than 1, any increase in the corresponding predictor leads to the decrease of the predicted probability. For example, the Exp(B) value associated with independent of board committee (IBC) is 0.016 for the period after introduction CG Codes (2000-2004). Hence, when IBC is raised by one unit the predicted probability of occurrence is 0.016 times large.

Board practices have been prominently discussed in the literature since the board has a vital role to play in a company as its function is to manage and direct the management (Hapsoro, 2006; Brend & Patrick, 2011). The logistic regression tests generated results that over two periods, from 2000 up to 2004 (after the introduction of CG Codes) and from 2005 up to 2009 (after converging to IFRS), the existence of independent board committee was not statistically significant related to IS practice at p= 0.504 and at p=0.445 with á=0.1 (Table 7). For the Indonesia case this non-significant association could be attributed to the factor that Indonesian listed company being dominated by

the majority shareholders most of external board commissioners were not totally "independent" in the incumbent management and also some of them were pointed as independent due to their close relationship with the major shareholders (Nuryanah, 2011) and also they are pointed due to their previous high position in the bureaucracy (e.g. retired politicians and army personnel) (Tabalujan, 2002), because of that many board members are not independent from each other (Tabalujan, 2002). Therefore, the revision of the corporate governance codes, corporate laws and listing requirements does not guarantee compliance and implementation in practice of good corporate governance in Indonesian companies.

It is generally believed that an independent audit committee provides effective monitoring of the financial discretion of management and in ensuring the credibility of the financial report quality. However, the logistic regression (Table 7) results indicate a negative relation (á=0.1) between IS practices and the percentage of independent audit committee of Indonesian listed firms on the level of p= 0.727 for the period after the introduction of CG Codes (2000-2004) and of p= 0.584 for after the period of the convergence to IFRS (2005-2009). It means that independent audit committee did not have ability to constrain IS practices. Within Indonesian case, some research have concluded that most of Indonesian listed companies have audit committees but audit committees are not entirely independent (Daniel, 2003) and also in Indonesian firms the audit committees are largely for the sake ceremonial and procedural compliance rather than quality compliance; therefore, they are largely ineffective in improving financial reporting process.

This research finding is the same with other research in developing countries such as in India (Sanan & Yadav, 2011), in Uganda (Nkundabanyanya *et al.,* 2011) and in Tunisian (Klai & Omri, 2011) find that majority of companies listed on the stock exchange tend to comply with all regulations imposed on them, such as the requirement to disclose audit committee reports, although they were not much concerned with the quality of these reports. This implies adversely on the corporate governance practice, audit committee duty and hence the quality of financial reporting.

The primary purpose of the external audit function is to give opinion and to obtain reasonable assurance that financial statements are free of material misstatement. This study aims to test if the external audit has a significant effect to the practice of IS. Therefore, as stated in hypothesis H5, it is hypothesized that there is a significant relationship between the IS practices and the quality of external audit firms. The logistic regression results in Table 7 show that external audit quality has a low significant relationship (ád"0.1) with IS practices for two periods, during the financial crisis (1995-1999) at p= 0.084 and after the introduction of CG Codes (2000-2004) at p= 0.080, but it has higher significant relationship (ád"0.05) at p=0.040 after the convergence to IFRS (2005-2009).

After the convergence to IFRS in 2005 there was a positive association (ád"0.05) between external audit quality and the income smoothing practices at p= 0.040 (Table 7). The possible explanation is that after the financial crisis period the economy was more stable and this created a major challenge for managers and external audit seeking to maintain investors' confidence in companies' performance. Auditing is expected to serve as a monitoring role to reduce agency costs between the managers and the firms' stakeholders. The finding shows that high quality external audit can constrain IS practices and can provide more precise financial information. This research finding is in line with the research conducted by O'Sullivan *et al.* (2008) and Krishnan (2005), which find that large audit firms are perceived to perform higher quality audit than smaller audit firms. Similarly, a recent research within the Indonesia setting by Nuryanah *et al.,* (2011) also provides evidence that 'the big five' auditors are related to less earning management practices of Indonesian listed firms.

CONCLUSION, LIMITATION, AND SUGGESTION

Conclusions

This study has found sufficient evidence that the IS practices by Indonesian listed firms get lesser after the introduction CG Codes and the convergence Indonesian accounting standards to IFRS, but occurrence of IS practices in Indonesian listed firms was still high (51%) after the introduction of some regulations. Consequently, the regulators and standard setters in Indonesia should realize that the big challenge is not merely

on releasing standards and regulations but is on ensuring that they can be well- socialized, implemented and monitored. Therefore, efforts should be directed not only at developing rules and regulation but most importantly at promoting awareness of using appropriate accounting standards as a good means for sustainable and responsible financial accounting practices.

Limitations

The limitation of this research was, this study has focused on publicly listed companies in Indonesia, as an emerging capital market. Therefore, the findings reported in this study might not be generalizable to other firms in other countries with different economic and business settings.

Suggestions

The suggestions for future research that further research may add other characteristics of the boards of directors and audit committee, for the boards of directors, other characteristics, such as the tenure or the total number of meetings of the board committee may serve as additional characteristics of their independent monitoring ability. For audit committee, additional characteristics such as the number of audit meetings, the proportion of the audit committee members with accounting or financial expertise, and their previous experiences activities might be included to detect their effects on IS practices.

REFRENCES

Adekoya, A. A. 2011. “Corporate governance reforms in Nigeria: challenges and suggested solutions”. *Journal of Business Systems”. Governance and Ethics.* 6 (1):38-50.

Arifin, Z. 2003. “Masalah Agensi dan Mekanisme Kontrol pada Perusahaan dengan Struktur Kepemilikan Terkonsentrasi yang Dikontrol Keluarga: Bukti dari Perusahaan Publik di Indonesia”. Unpublished *Ph.D Thesis.* Faculty of Management and Accounting. Universitas Indonesia. Indonesia.

Aussenegg, W., Inwinkl, P. and Schneider, G. 2008. “Earnings management and local versus International Accounting Standards of European public firms”. *SSRN Working Paper.* Electronic copy available at*:* http://ssrn.com/abstract= 1310346.

Ball, R., Robin, A. and Shuang, J.W. 2003. “Incentives versus standards: properties of accounting income in four East Asian countries”. *Journal of Accounting and Economics.* 36:235–270.

Barth, M. E., Landsman, W.R. & Lang, M.H. 2006. “International accounting standards and accounting quality”. *Working Paper.* Stanford University. Availabel at: http://ssrn.com/abstract=688041.

Bauwhede, H.V. and Willekens, M. 2003. “Earnings management in Belgium: A review of the empirical evidence”. *Tijdschrift voor Economie en Management,*. XLVIII(2):199- 217.

Bhattacharya, N., Black, E., Christensen, T. and Mergenthaler, R. 2004. “Empirical evidence on recent trends in pro forma reporting”. *Accounting Horizons*, 18, (1):27- 41.

Brend, B. & Patrick, K. 2011. “Corporate governance and corporate performance: A German perspective”. *International Journal of Management Cases*, 12:327-340.

Chatterjee, D. 2011. Audit committee observation/recommendations versus practices as a compliance of corporate governance in India. *Del La Salle University Business & Economics Review.* 20(2):67-78.

Chong, G. 2008. “Is the income smoothing ethical”? *The Journal of Corporate Accounting & Finance.* Nov/Dec: 41- 44.

Collin, S.Y., Tagesson, T., Andersson, A., Cato, J. and Hanson, K. 2009. “Explaining the choice of accounting standards in municipal corporations:

Positive accounting theory and institutional theory as competitive or concurrent theories". *Critical Perspectives on Accounting*, 20:141–174.

Daniel, W.E. 2003. "Corporate Governance in Indonesian Listed Companies: A Problem of Legal Transplant". *Bond Law Review.* 15(14):1-33.

Davidson, R., Stewart, J.G. and Kent, P. 2005. "Internal governance structures and earnings management". *Accounting and Finance*. 45:241–267.

Davidson, W.N., Bouresli, A.K. and Singh, M. 2006. "Agency costs, ownership structure, and corporate governance in pre and post IPO firms". *Corporate Ownership & Control.* 3(3), Spring 20:88-97.

Elena, H., Marian, S. & Dorel, M. 2011. "The IAS/IFRS standards system between harmonization and deformity". *Working Papers.* University Of Timisoara West. Faculty of Economics and Business Administration. 868-878.

Fan, P. H., and Wong, T.J. 2005. "Do external auditors perform a corporate governance role in emerging markets? Evidence from East Asia". *Journal of Accounting Research.* 43(1):35-72.

Habib, A. 2005. "Firm specific determinants of income smoothing in Bangladesh: An empirical evaluation". *Advances in International Accounting*. 18:53–71.

Hapsoro, Dody. 2006. "Mekanisme corporate governance, transparansi dan konsekuensi ekonomis: Studi empiris di pasar modal Indonesia". Unpublished. *PhD Thesis*. Gajah Mada University. Indonesia.

IAI (Indonesian Institute of Accountant). 2009. *Info umum IAI*. Available at: http://www.iaiglobal.or.id/tentang_iai.php?id=6. Accessed on 20 July 2010.

IDX (Indonesia Stock Exchange). 2002. *Decision Letter of PT Bursa Efek Jakarta No.: Kep-309/BEJ/07-2001*. Available at: http://www.idx.co.id/. Accessed on 10 July 2009.

Jeanjean, T. and Stolowy, H. 2008. "Do accounting standards matter? An exploratory analysis of earnings management before and after IFRS adoption". *Journal Accounting Public Policy*. 27:480-494.

Kang, S.A. and Kim, Y.S. 2011. "Does earnings management amplify the association between corporate governance and firm performance? Evidence from Korea". *International Business Economies Research Journal.* 10(2):560-573.

Kim J. and C. Yi. 2006. "Ownership structure, business group affiliation, listing status, and earnings management: Evidence from Korea". *Contemporary Accounting Research.* 23(2):427-464.

Klai, N., & Omri, A. 2011. "Corporate governance and financial reporting quality: The case of Tunisian firms". *International Business Research.* 4(1):158-169.

Krishnan J. 2005. "Audit committee quality and internal control: An empirical analysis". *The Accounting Review.* 80(2):649-675.

Krishnan, J. 2003. "Audit quality and the pricing of discretionary accrual". *Journal of Auditing*. 22:109"126.

Leuz, C., Holgerdaske, H. L. 2008. "Mandatory IFRS reporting around the world: Early evidence on the economic consequences". *Journal of Accounting Research.* 46(5):1085-1142.

Liliana, F., Niculae, F. & Dragomir, D.V. 2011. "Corporate governance in emerging economies: The case of Romania". *Theoretical and Applied Economics.* 9(562):5-16.

Lin, F.L. 2011. "Is earnings management opportunistic or beneficial in Taiwan? Application of panel smooth transition regression model". *Interna-*

tional Journal of Economics and Finance. 3(1):133-142.

Machuga, S. and Teitel, K. 2007. "The effects of the Mexican Corporate Governance Code on quality of earnings and its components". *Journal of International Accounting Research.,* 6(1):37-55.

McAnally, M. L, McGuire, S.T. & Weaver, C. D. 2010. "Assessing the financial reporting consequences of conversion to IFRS: The case of equity-based compensation". *Accounting Horizons*. 24(4):589–621.

McClave, J.T., Benson, P.G. & Sincich, T. 2011. *Statistic for Business and Economics.* Boston MA: Pearson Education Publication.

McKinsey & Co. 2006. *Global investor opinion survey: Key findings*. Available at www.mckinsey.com/governance. Accessed on 20 April 2009.

Nkundabanyanga, S. K. & Sserwanga, A. 2011. "Firm risk profile, agency incentives and corporate performance: Corporate governance perspective of Uganda". *Journal of Modern Accounting and Auditing*. 7(3):239-251.

Nuryanah, S., Sardar, M. & Islam, N. 2011. "Corporate governance and performance: Evidence from an emerging market". *Malaysian Accounting Review.* 10(1):17-42.

O'Sullivan, M., Percy, M., Stewart, J. 2008. "Australian evidence on corporate governance attributes and their association with forward-looking information in the annual report". *Journal Manage Governance*. 12:5–35.

Sanan, N. & Yadav, S. 2011. "Corporate governance reforms and financial disclosures: A case of Indian companies". *The IUP Journal of Corporate Governance*, X(2):62-81.

Shen, C.H. and Chih, H.L. 2007. "Earnings management and corporate governance in Asia's emerging markets". *Journal of Corporate Governance.*15(5):999-1021.

Siregar, S.V. & Utama , S. 2008. "Type of earnings management and the effect of ownership structure, firm size, and corporate governance practices: Evidence from Indonesia". *The International Journal of Accounting*. 43:1-27.

Stolowy, H. and Bartov, G. 2004. "Accounts Manipulation: A Literature Review and Proposed Conceptual Framework". *Review Accounting and Finance*, 3(1):1- 62.

Susanti, A. S. 2008. "Pengaruh Kualitas corporate governance, kualitas audit an earning management terhadap kinerja perusahaan". Unpublished. *Master Thesis*. Sekolah Tinggi Ilmu Ekonomi YKPN, Indonesia.

Tabalujan, B.S. 2002. "Why Indonesian corporate governance failed – Conjectures concerning legal culture". *Columbia Journal of Asia Law.* Spring:1-37.

Warsame, M.H. 2006. "An empirical analysis of the impact of adopting International Financial Reporting Standards: Evidence from emerging African capital markets". Unpublished. *Ph.D Thesis*. Morgan State University. USA.

World Bank. 2004. *Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: Republic of Indonesia*, Available at http://www.worldbank.org/ifa/rosc_cg_idn.pdf. Accessed on 12 July 2009.

Xie, B., Davidson, W.N. & DaDalt, P.J. 2003. "Earnings management and corporate governance: The role of the board and the audit committee". *Journal of Corporate Finance*. 9:295-316.

Yang, C.Y., Murinde, V. and Ding, X. 2008. "Ownership structure, corporate governance and income smoothing in China". *Working Paper.* Department of Business, Economics & Management, Xi'an Jiaotong -Liverpool, China. 1-28.