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Supervisory Board and Audit Quality Post Revised Code of Corporate Governance: The Case of Indonesia Listed Companies

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Abstract

Indonesia is a unique of corporate governance system. Even, Indonesia follow the Europe Continental Corporate Governance System, the appointment and dismissal of supervisory board is different compare to the common practice in Continental Europe countries, such as Nederland. Code of Corporate governance is code of conduct that should be followed by the company in order to be perceived as having been practiced the principle of corporate governance. In Indonesia, code of corporate governance has been revised in 2006. However, there is a limited study conducted post this revision in Indonesia, especially its effect in audit quality. Therefore, this study intent to investigate the effect of the supervisory board on audit quality. By using 218 companies for three years, we find that supervisory board size and age have a positively significant relationship with the audit quality as predicted by resources dependent theory. In addition, profitable, higher financial risk and large companies tend to select the higher quality of audit firm. However, this finding fail to confirm the agency theory. The finding of this study have a number of an important implication for future practice, such as the mechanism of selecting and dismissing supervisory board independent.

Keyword; Corporate Governance, Supervisory Board, Audit Quality and Indonesia listed companies.

1. Introduction

The role of corporate governance in financial reporting quality has been debated over the decade. Supervisory board is one of the internal mechanisms to limit the discretionary behavior of the management and enhance the financial information quality. In addition, this condition led to the investor confidence to invest a particular company. Therefore, the good practice of corporate governance is an essential in a company. Indonesia started implementing the principle of corporate governance in the beginning of the year 2000. It was marked by establishing the forum for corporate governance and it released the code of corporate governance in early year of 2000.

There are two type of corporate governance system: Anglo-Saxon Corporate Governance and Continental Europe System. The later system has the two-tier board system (Supervisory Board and Management Board). Indonesia follows the Continental Europe System and the way supervisory board is appointed and dismissed, however, differ compared to the original system. The role of supervisory board as internal corporate governance mechanism in financial reporting quality has been suggested by Cohen et al (2004). In addition, many researchers have documented the significant effect of the existence of supervisory board on financial reporting quality (see for example, Osma, 2008; and Osma & Noguer, 2007).

To get the higher quality of financial report, the supervisory board and management have to select the higher quality of external auditor or audit firm. This term is well known as the audit quality. The issue of audit quality is at the heart of the agency theory and corporate governance since the demand for the external auditor is to reduce the opportunistic behavior of management and agency conflict, and protect the shareholder interest by ensuring the relevance and reliability of financial statement (Gana & Lajmi, 2011). Audit quality is the probability that the auditor discover the material misstatement and report in the company accounting system (DeAngelo, 1981b). Therefore, the higher audit quality increase the chance to detect any material misstatement in the financial report and the shareholder can gain access to information that is more useful (Wan-Abdullah, Ismail & Jamalludin, 2008).

The research that investigates the relationship between board characteristics and audit quality has been largely done. However, most of studies are conducted in Anglo-Saxon Corporate Governance System, such as US and UK (see for example, O'Sullivan, 2000; Beasly

&Petroni, 2001; Carsello, Hermanson, Neal & Riley, 2002; and Boo & Sharma, 2008). In emerging market, investigation on audit quality has also been done in Egypt (Suliman & Abd-Salem, 2012), Malaysia (Wan-Abdullah, Ismail & Jamaluddin, 2008), Tunisia (Makni, Kolsi & Affes, 2012) and among others. However, study in Continental Europe Corporate governance system is still limited as far as we concern (such as study was conducted in France, Germany and Canada by Piot (2005)). In addition, there is also lack of study has been done by using the supervisory board as determinants of the audit quality in Indonesia. Further, Indonesia has been revised the code of corporate governance in 2006. Besides, Indonesia government very much concern with the financial accounting information quality and it is evidenced by implementing the financial accounting standard that complied with the IFRS in early 2012. This condition may enrich the corporate governance and audit quality literature. Thus, this study aims to investigate the relationship between supervisory board characteristic and audit quality post revised code of corporate governance. Supervisory board characteristics in this study consists of the composition, size, shareholding, knowledge and expertise, and experiences.

2. Theoretical foundation and hypothesis development

The role of Supervisory Board lies in the agency theory (Jensen and Meckling, 1976). In addition, Supervisory Board has function to reduce the dysfunctional behavior and therefore, agency problem and cost. In term of accounting quality, Supervisory Board can oversee the financial reporting process (Cohen et. al, 2004). Supervisory board (also known as board of commissioner) is an organ of the company that have function and responsible collectively for overseeing and providing advices to the Board of Directors and ensuring that company implement the corporate governance principles (NCG, 2006). In addition, NGC (2006) emphases on the several characteristics of supervisory in order to be able to effectively exercise their duties, (i) the composition of the board of supervisory board shall enable them to make effective, right and timely decision and to act independently, (ii) the members of the Supervisory Board must be professional that possess the integrity and capability to enable them to carry out their function properly including to ensure that the Board of Director shall observe the interest of all stakeholders, and (iii) the oversight and advisory function of the Supervisory Board include the act of preventing, improvement, and suspension.

2.1. Supervisory Board Composition

Composition of Supervisory Board refers to the ratio of the supervisory board from outside to total board members. Outside Supervisory Board is also known as the supervisory board independence. Supervisory board independence has a particular incentive to prevent and detect the opportunistic reporting behavior by management (Fama and Jensen, 1983). To protect its reputation capital, avoid legal liabilities, and promote the shareholder interests, a more independent supervisory board may demand differently higher audit quality which is greater assurance (Carcello, Hermanson, Neal and Riley, 2002). In addition, Carcello et al (2002) find that there is a positive relationship between board independence and audit quality. Further, Soliman and Abdul-Elsalam (2012) also documented the positive significant relationship between Board Independent and audit quality in Egyptian company. Other study done by using the Belgium public company also concludes the positive relationship between board independent and audit quality (Gana and Lajmi, 2011). Therefore, the first hypothesis is as follow

H1: There is a significant positive relationship between supervisory board composition and audit quality

2.2. Supervisory Board Size

Supervisory board size refers to the number of supervisory board in a company. There are two arguments regarding to the board size. Jensen (1993) consider that large number of board would bring to the inefficient monitoring due to the communication and decision making process problem. In contrast, Pearce and Zahra (1992) state that large number of board increase the board performance due to the ability of board to bring the external resources into company. In addition, Gana and Lajmi (2012) find that a positive significant relationship between board size and audit quality. However, Krishnan and Visvananthan (2009) investigate the relationship between board size and audit quality, and thus, conclude that there is no significant effect of the board size and audit quality. Based on the theoretical reason and previous study, we offer the second hypothesis.

H2: There is a significant positive relationship between supervisory board size and audit quality.

2.3. Supervisory Board Shareholding

Supervisory board shareholding refers to board owning the company share. The contention of the board shareholding come from Jensen and Meckling (1976). They argue that board should have small portion of stock in order to reduce gap between the interest of board and shareholder interests. Therefore, there is alignment between board and shareholder. In addition, Monk and Minow (1995) argue that the role of board become effective, it is not just because they have economic ties with the company, but also they are shareholders. Therefore, supervisory board with share would choose the high quality of external auditor because the high quality external auditor contribute to the high quality of accounting information. Thus, the next hypothesis is as follow,

H3: There is a significant positive relationship between supervisory board shareholding and audit quality.

2.4. Supervisory Board Knowledge and Expertise

The role of supervisory board knowledge and expetice in financial reporting process come from the resources dependent theory. This theory views that knowledge and expertice is often conceptuaized as stock of information or background expertice that board member have (Payne, Benson, and Finegold, 2009). Sonnefelt (2002) classified the knowledge as business strategy, finance, Law, Governance, technology and society. In fact, Ravasi and Zattoni (2006) argue that baord member should have functional knowledge, such as accounting, finance and marketing. In addition, Rindova (1999) suggest that board member should have expetice in form of problem solving, communication and team work. Therefore, supervisory board with knowledge and expertice would select the higher quality of external auditor. Thus, the following hyphtesis offer

H4: There is a significant relationship between supervisory board knowledge and expertise and audit quality.

2.5. Supervisory Board experience

Supervisory board experience is another determinants of the audit quality (Gana and Lajmi, 2011). In addition, Board experience might further involve themselves in the promotion of company advantage (Kroll, Walters, and Wright, 2008). In line with Kroll et al (2008), Daya, Lonie and Power (1996) add that board experience would help in making information more transparence. Further, Kaplan and Reishus (1990) argue that board of director experience is more likely to have greater incentives to monitor effectively and safeguard their reputation. Thus, supervisory board would prefer to choose the higher quality of external auditor to safe their reputation. Abdelsalam and Street (2007) classify the board experience into three proxy, which are age, directorship and tenure. Previous research conducted by Gana and Lajmi (2011) conclude that there is significant relationship between board experience and audit quality. Therefore, the next hypothesis is as follow,

H5: there is a significant relationship between supervisory board experience and audit quality.

3. Sample, data and model

We use the public listed company as object of this study. Based on the availability of data, we get the 218 companies (44.9% of total population). However, we utilize the three year data from 2006 to 2008 which come the total number of observation is 654 companies-years. Secondary data is used which are from multiple sources (annual report, Indonesia Capital market Directory, company websites and other sources). Further, there are three type of variables in this study, dependent variable (Audit Quality), independent variables (Supervisory Board Composition, Size, Knowledge and Experience, Shareholding, and Experience). Control variables (ROA, LEV, and SIZE).

Audit quality is a dummy variable which assign 1 if company is audited by a big 4 and otherwise. Supervisory board composition is measured by number of supervisory board independent to total board members. In addition, supervisory board size is total number of supervisory board as proxy. Further, supervisory board knowledge and expertise is measured by the ratio of number of supervisory board has an academic background of business and management to total board members. Thus, supervisory board experience is measured by three proxy, (i) Supervisory board age, (ii) supervisory board multiple directorship, and (iii) supervisory board tenure. Finally, the ROA is net income per total asset and debt to asset ratio is proxy for leverage. SIZE is a company size which measured by total asset. The research model is as follow,

$$AQ_{it} = a + \beta_1 BC_{it} + \beta_2 BZ_{it} + \beta_3 BS_{it} + \beta_4 BEK_{it} + \beta_5 BED_{it} + \beta_6 BEA_{it} + \beta_7 BET_{it} + \beta_8 ROA_{it} + \beta_9 LEV_{it} + \beta_{10} SIZE_{it} + e$$

In this study, we use the panel data analysis with *Logit* model. This model is applied to the typical data of dependent variable that is categorical variable. Therefore, the *Logit* model procedure is applied to this study.

4. Result and Discussion

This section discuss about the result of this study. This study finally have the 218 companies as sample. The table 4.1 shows the descriptive statistics.

Table 4.1
Descriptive Statistic

No	Variables	Descriptive Statistic before Outlier Test (n=654)			
		Min	Max	Means	SD
1	AQ	0	1	0.41	0.49
2	BC (%)	0	100	41.03	14.71
3	BZ (person)	1	12	4.33	1.91
4	BS	0	1	0.16	0.37
5	BEK (%)	0	100	49.98	24.87
6	BED (%)	0	100	64.23	28.49
7	BEA (years)	27.5	82.6	55.35	6.34
8	BET (years)	0.2	20.5	5.64	3.65
9	ROA (%)	-130	62.2	3.65	13.19
10	LEV (%)	0	238	53.31	29.78
11	SIZE (billion)	0.4	57929	5696.15	12489.51

Note; AQ is audit quality, BC is Board Composition, BZ is Board Size, BS is Board Shareholding, BEK is Board Expertise & Knowledge, BED is Board Experience (Multiple Directorship), BEA is board experience (Age) , BET is Board Experience (Tenure), ROA is return on asset, LEV is debt to asset ratio, and SIZE is company size

We use the regression analysis to reject hypothesis. However, checking for outlier is firstly conducted by using the Grubb test procedure to detect and remedy the outlier data (Grubb, 1969). The result of the outlier test reported in Table 4.2 below.

Table 4.2
Result of Outlier Test

No	Variables	Outlier		Descriptive Statistic After Outlier Remedy (n=654)			
		# of Obs	%	Min	Max	Means	SD
1	AQ	-	0	0	1	0.41	0.49
2	BC	7	1.07	0	75	40.69	13.57
3	BZ	2	0.31	1	10	4.32	1.88
4	BS	-	0	0	1	0.16	0.37
5	BEK	0	0	0	100	49.98	24.87
6	BED	0	0	0	100	64.23	28.49
7	BEA	3	0.46	36.3	76	55.36	6.2
8	BET	1	0.15	0.2	19.7	5.64	3.64
9	ROA	5	0.76	-26.1	34	3.46	7.88
10	LEV	1	0.15	0	158	53.11	28.36
11	SIZE	12	1.83	0.4	29706.9	3751.96	6807.35

The next analysis is normality test. We utilize the Kurtosis and Skewness to detect normality. In addition, transformation is applied if variables are not normal. The role of thumb say that Tolerance value of kurtosis and skewness is + 1 and – 1. The result of detection and remedy for normality is presented table 4.3 below.

Table 4.3
Normality Test and Transformation

	Skewness		Kurtosis		Transformation	Skewness		Kurtosis	
Variable	Stat	SE	Stat	SE		Stat	SE	Stat	SE
AQ	0.38	0.1	-1.86	0.19	dummy				
BC	0.35	0.1	0.86	0.19	none needed	0.35	0.1	0.86	0.19
BZ	1.1	0.1	0.91	0.19	Square root	0.63	0.1	-0.02	0.19
BS	3.38	0.1	10.36	0.19	dummy				
BEK	0.04	0.1	-0.3	0.19	none needed	0.04	0.1	-0.3	0.19
BED	-0.53	0.1	-0.34	0.19	none needed	-0.53	0.1	-0.34	0.19
BEA	-0.1	0.1	0.98	0.19	none needed	-0.1	0.1	0.98	0.19
BET	1.36	0.1	2	0.19	Square root	0.527	0.1	0.174	0.19
ROA	0.63	0.1	4.98	0.19	normal score*	-0.01	0.1	-0.19	0.21
LEV	0.47	0.1	0.96	0.19	none needed	0.47	0.1	0.96	0.19
SIZE	2.77	0.1	7.22	0.19	Logarithma	-0.48	0.1	0.24	0.19

*The data were transformed by computing normal scores using Van der Waerden's transformation defined by the formula r/(w + 1), where w is the sum of the case weight and r is the rank ranging from 1 to w (see Owunsu-Anshah and Levemtis, 2006).

The multicollinearity problem is detected by using the Pearson-Correlation. The result (see table 4.4) show that there is no significant higher correlation among the independent variable and we can conclude that there is no multicollinearity problem in this model.

Table 4.4
Result of Pearson-Correlation

Ind. Var	BC	BZ	BS	BEK	BED	BEA	BET	ROA	LEV	SIZE
BC	1									
BZ	-0.06	1								
BS	-0.07	-0.08	1							
BEK	0.06	-0.00	-0.06	1						
BED	-0.15**	0.12**	-0.02	0.02	1					
BEA	0.03	0.15**	0.05	-0.10**	0.00	1				
BET	-0.09*	-0.13**	0.04	-0.08*	0.02	-0.28**	1			
ROA	-0.00	0.20**	-0.06	-0.03	-0.04	0.10**	-0.01	1		
LEV	0.05	-0.02	-0.04	0.06	-0.05	0.09*	-0.01	-0.25**	1	
SIZE	0.04	0.45**	-0.14**	-0.03	-0.02	0.18**	0.03	0.24**	0.09*	1
Notes: two-tailed, * and ** significant at 5% and 1% respectively										

This study use a panel data approach to reject hypotheses and utilize the e-views software. The Hosmer and Lemeshaw test is applied to see the feasibility of model and the result show that that the model is feasible. It is indicated by H-L test of 7.9258 with the significant value of 0.4407 which is greater than 0.05. In addition, it means that no significant difference was found between the classifications of the observed and predicted. To regress data, binary logic model (BLM) use with option of quadratic hill climbing. To describe How far the independent variables could explain the dependent variable use the McFadden R-Square. In addition, McFadden R Square is 0.2159 which means that supervisory board characteristics and control variable could explain the audit quality about 21.59% and the rest is explained by other variables which is excluded in this study.

Table 4.5
Regression Result
(Audit Quality or AQ as Dependent Variable)

No	Variables	Coefficient	Standard Error	Z statistic	Probability
1	C	-9.520848	1.257834	-7.569243	0.0000
2	BC	-1.625563	0.727537	-2.234336	0.0255**
3	BZ	1.183916	0.252201	4.694346	0.0000***
4	BS	-0.483055	0.273838	-1.764021	0.0777*
5	BEK	-0.437974	0.38084	-1.150019	0.2501
6	BED	0.091781	0.335271	0.273751	0.7843
7	BEA	0.051295	0.017198	2.982582	0.0029***
8	BET	-0.086951	0.133322	-0.652185	0.5143
9	ROA	0.493815	0.106577	4.633406	0.0000***
10	LEV	0.721507	0.364344	1.980293	0.0477**
11	SIZE	0.751536	0.131605	5.71055	0.0000***

Note: * significant at 10%, ** significant at 5% and *** significant at 1%

The result of regression is shown in Table 4.5. Surprisingly, the first hypothesis is rejected due to negative direction of the effect supervisory board on audit quality. Thus, it means that supervisory board independence is not likely to select the higher quality audit firm. However, this finding do not support the previous researches, such as Carcello et al (2002), Soliman and Abdul-Elsalam (2012), and Gana and Lajmini (2011). In addition, a possible explanation for this might be that board independence may engulf the company in excessive monitoring (Bayersinger and Butler, 1985) and may lack the business knowledge to be truly effective (Paton and Baker, 1987). In addition, board independent might lack real independent (Demb and Neubeuer, 1992). In Indonesia, supervisory board independents appoint and dismiss by shareholders. Therefore, the shareholder would be select the board that benefit them.

Turning now to the second hypothesis which state that there is a positive relationship between supervisory board size and audit quality. The result indicate that this second hypothesis is accepted. It is encouraging to compare this finding with that found by Gana and lajmi (2012). However, this result differ from Krishnan and Visvananthan (2009) who find that there is no significant relationship between board size and audit quality. This result may be explained that by the fact that large number of supervisory board bring to diverse capability and resources as suggested by resources dependent theory (Pearce and Zhara, 1992). Contradict to the third hypothesis, supervisory board with share is less likely to select the higher quality of audit firm. It indicate by the negative signal of the effect of board shareholding on the audit quality (significant at 10%). The present study do not seem to be consistent with the idea of Monk and Minow (1995) which argue that board with share become effective.

Supervisory board knowledge and expertise does not have a significant effect on the audit quality due to the p value greater than 0.05. The fifth hypothesis is partially accepted. Supervisory board age is positive significantly associated with the audit quality. It means that older supervisory board tends to select the higher audit firm. This finding is consistent with the finding of Gana and Lajmi (2012) who conclude that older supervisory board tend to have experience and therefore, choose the higher audit firm.

Three control variables have a significant relationship with the audit quality. In addition, ROA is proxy for profitability and the result show that profitable company tend to have the higher audit firm. Thus, company with higher debt also tend to select the higher quality audit firm. Further, large company would elect the higher audit firm to audit its financial statement. The reason for this is not clear but it may have something to do with the ability to pay the higher audit fee for big 4 audit firm.

5. Conclusion, Implication and Suggestion for future research

Supervisory board is assigned to reduce the management dysfunctional behavior. Regulation framework used to guide the company in a country is code of corporate governance. In Indonesia, Code of Corporate Governance has been revised in 2006. In this revision, the role of supervisory board had been strengthened in order to reduce the agency conflict and improve the accounting information quality and finally, increase the company performance. However, study to investigate the role of supervisory board on audit quality is rare, especially in Indonesia. Such business, system and culture of Indonesia might enrich the literature of corporate governance. In this investigation, the aim was to assess the role of supervisory board on audit quality.

This study have five hypothesizes and use 281 companies listed Indonesia stock exchange from 2006 to 2008 (Post revision Code of Corporate Governance). From the result, we can conclude that supervisory board size and experience have a significant positive relationship with the audit quality. In contrast, supervisory board composition and shareholding are negatively significant associated with audit quality. However, supervisory board knowledge and expertise, tenure, and multiple directorship do not have any significant relationship with audit quality. One of the more significant findings to emerge from this study is that size and experience of supervisory board determining the audit quality as predicted by resources dependent theory. Whilst this study did not confirm agency theory. The evidence from this study suggest that in order to have the higher quality of audit firm, the number and age of supervisory board should be large and much older.

A number of important limitations need to be considered. First, this study do not considered other variable, such as audit committee as determinant of the audit quality. Second, the study did not classify sample into different industry. And finally, this study use the limited data which is from 2006 t0 2008. Therefore, this research has thrown up many question in need of further investigation by searching other variables that might determine the audit quality. Thus, future research also can add the number of sample and data to get the more robust result.

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