CHAPTER I

INTRODUCTION

1.1 Background

Corporate governance has been the subject of an ongoing debate among academics, regulators, and practitioners, and its effectiveness remains controversial in the aftermath of the recent financial crisis (Carcello, Hermanson & Ye, 2011; Barua, Davidson, Rama & Thiruvadi, 2010). Recent corporate financial scandals, such as Enron, WorldCom, and Tyco, have caused shareholders, investors, and the public to lose confidence in many of the parties involved in the financial reporting process (Butar, 2018). In respect to this issue, many parties demanded for improvement in corporate governance mechanism or which usually referred to as good corporate governance (GCG), because good corporate governance is said to be associated with good accounting outcomes, or at least help ensuring the integrity of financial reporting process (Beasley, 1996; Dechow et al., 1996; Carcello et al., 2011)

Financial reports are written records that convey the business activities and the financial performance of a company. The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making (FASB, 1999 in Jonas and Blanchet, 2000). Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall market efficiency.

The fact that publicly-held companies have an obligation to publish their financial report annually to the public, makes it more necessary and at the same time, creates the expectation for companies to provide credible financial reports (Butar, 2018). According to the Financial Accounting Standards Board (FASB) Conceptual Framework (Jonas and Blanchet, 2000), quality of financial report must be defined in terms of the overall objective of financial reporting, i.e., to provide users with information useful for making investment, credit, and similar decisions. The FASB then adds that for financial report to be of good quality, it must provide accurate and fair information about the underlying financial position and economic performance of an entity. The quality of financial information can also be defined in relation to providing shareholder or investor protection. In that context, quality of financial reporting is full and transparent financial information that is not designed to obfuscate or mislead users.

When financial reporting does not tell the whole story, it creates uncertainty, and therefore increases the risk of having misleading or less profitable decisions among the financial report users. Beasley et al. (2010) as cited in Carcello et al. (2011) find that weaker governance will result in higher chance of financial reporting fraud. While previous research by Bowen et al. (2008) in Carcello et al. (2011) documents that poor corporate governance is associated with greater accounting discretion. Ashbaugh-Skaife et al. (2005) and Doyle et al. (2005) also suggest that weak internal controls can lead to low quality accounting accruals from intentional earnings management and unintentional accounting errors (Carcello et al., 2011). These findings suggest that poor control and monitoring result in lower firm's performance (Abbott et al., 2012; Beasley, 1996; Dechow et al., 1996; Ittonen et al., 2013; Klein, 2002; Xie et al., 2003).

In an attempt to restore trust and to improve the quality of financial reporting, Butar (2018) suggests that an effective monitoring mechanism should be established within a company. The effectiveness of monitoring mechanisms lies on the characteristics of the monitoring personnel itself. Brown & Popova (2016); Krishnan (2005); and Prawitt et al. (2009) describes the positions given the oversight responsibility of the financial reporting process include company management, the external and internal auditor, the audit committee, and the board. These researches believe the existence of mentioned personnel is helping to shape financial reporting quality.

Since the pioneering governance work of Beasley (1996) and Dechow et al. (1996), a lot of prior accounting and auditing researchers have published studies examining the relation between corporate governance characteristics and various accounting outcomes, such as fraudulent financial reporting, restatements, earnings management or accruals quality. What constitutes as good accounting outcomes typically is defined as less earnings management (Klein, 2002), or the absence of fraudulent financial reporting (Beasley, 1996; Beasley et al., 2000) or restatements (Abbott et al., 2004).

To explain further, many literatures have examined varied set of characteristic pertaining to the monitoring personnel, how it affects the monitoring effectiveness, and ultimately what kind of outcomes that companies receive. In terms of independence, firms with audit committees composed mainly or in whole of independent directors are negatively related to restatements and less likely to feature large discretionary accruals (Abbott et al., 2004; Klein, 2002; Xie et al., 2003). Xie et al. (2003) and Klein (2002) both find that accruals quality is associated with board independence, and Beasley (1996) finds that more independent boards have lower likelihood of fraud. In terms of expertise, previous researches find that the presence of financial experts on the audit committee are negatively related to the magnitude of discretionary accruals (Xie et al., 2003; Krishnan, 2005), financial restatement (Abbott et al., 2004), and internal control problems (Krishnan, 2005). At the board level, a higher degree of financial sophistication on the board are negatively related to discretionary accruals (Xie et al., 2003)

Beyond financial expertise, prior research also considers other characteristics such as size and number of meetings as indicators of monitoring quality. Some researches tend not to find an association of audit committee size with financial reporting or internal control quality (Abbott et al., 2004; Krishnan, 2005). On the other hand, Beasley et al. (2000) indicates fewer meetings can indicate lack of commitment and/or insufficient time for effective monitoring. Good accounting typically is defined as less earnings management (Klein, 2002), or the absence of fraudulent financial reporting (Beasley, 1996; Beasley et al., 2000) or restatements (Abbott et al., 2004). Taken together, these researches conclude that corporate governance structures contribute to the quality of financial reporting.

However, the tendencies of prior studies to use certain characteristic (e.g., independence, expertise, number of meetings, and size) of the corporate governance mechanism to assess monitoring effectiveness (Abbott et al., 2004; Klein, 2002; Krishnan, 2005; Beasley, 1996; Beasley et al., 2000; Xie et al., 2003) and mixed results that were found engender the question that maybe there are additional factors impacting monitoring effectiveness.

Larkin et al. (2013) believes that as more corporate scandals continue to surface, stakeholders have pushed for change within the corporate structure, in other words, there is the need for more diverse corporate personnel. Diversity is argued to be desirable for diversity has been advocated as a means of improving organizational value and performance by providing the board with new insights and perspectives. Research suggests that board diversity leads to a greater knowledge base, creativity, and innovation, therefore, provides competitive advantage to the organization (Adams and Ferreira, 2009; Carter et al., 2003).

In regard to diversity, many literatures document an increase in group decision-making efficacy when gender diversity is introduced. Prior literature suggests that gender influences individuals' ethical behavior as well as their ethical decision-making processes. For example, as discussed in detail later, research from diverse areas suggests that women tend to be less aggressive, more cautious, likely to be in compliance with rules and regulations in a variety of financial decisions (Byrnes et al., 1999). This results to the argument made by Barua et al. (2010), Ittonen et al. (2013), and Peni & Vahamaa (2010) who postulate that gender-based behavioral differences may have important implications for the quality of auditing and financial reporting.

Supporting these researches, number of studies show a positive link between financial reporting quality and the presence of gender-diverse boards (Abbott et al., 2012; Barua et al., 2010; Gul et al., 2013), on audit committees (Thiruvadi and Huang, 2011), on external auditors (Ittonen et al., 2013), or in senior management positions (Barua et al., 2010; Peni and Vahaama, 2010). This is broadly consistent with Adams and Ferreira (2009), who posit that board gender diversity may heighten the monitoring vigilance and overall lead to a better firm's performance.

On top of these, Adams and Ferreira (2009, p.292) suggest companies to form professional groups in which women are better represented as expanding the recruitment of women could result in a broader talent pool of applicants and thus improve boardroom effectiveness. Gul et al. (2013) states that many countries worldwide have argued that gender diversity improves board effectiveness and have therefore called for more female to be appointed to boards.

The overall weight of such evidence showing differential behavior of women in business leads to the argument whether having woman as monitoring personnel are associated with higher quality of financial reports. As stated previously, a stream of prior literature conducted mostly focus on certain measures of corporate governance effectiveness but there are only relatively limited research that focus on the gender aspect in monitoring mechanisms and its impact on understanding accounting outcomes and organizational performance.

Such studies are interesting because over the past decade, more women have become involved in full-time employment. In addition, according to a study by the American Institute of Certified Public Accountants in Gold et al. (2009), more than 50 percent of new accounting graduates are women; the vast majority of public accounting firms have made retention of female professionals a priority; and the turnover of women currently approximates that of men.

The motivation for this study comes from (1) concerns of whether monitoring by parties involved in financial report process can ensure good-quality financial reports in the aftermath of the financial scandals of the early 2000s (e.g., Enron, WorldCom, Tyco); (2) the assumption resulted from extent research that women and men may act and behave somewhat differently, and that the gender-based differences, for instance, in decision-making, may have important implications for the quality of financial reporting.

Overall, this study contributes to the corporate governance literature by examining the relatively ignored characteristic – gender – on financial report, specifically in Indonesia. This study is of interesting topics, because to writer's knowledge, empirical research that investigates the consequences of gender-differences on monitoring in Indonesia is still relatively small (such as Baihaqy & Kusuma, 2012; Kusumastuti et al., 2007; and Anggraeni & Djakman, 2017). Also, characteristics of corporate governance in Indonesia differ from other countries (Butar, 2018). In contrast with America, Indonesia (as mandated in Law No. 40 of 2007 on Limited Liability Companies) recognizes a two-tiered structure: the

Board of Commissioner acts as the supervisory board and the Board of Director acts as the management board.

As a result, the writer is motivated to examine the effectiveness of corporate governance mechanism and monitoring function as reflected in gender of board of commissioner, audit committee, and external auditor, for they hold the key responsibility in financial reporting oversight. As opposed to American researches, board of directors will be included not as main variable but as moderating effects on the three other monitors.

Finally, to answer the research question of whether the presence of women in the monitoring of a company have enough power to influence the quality of financial report, this study use a sample of manufacturing companies listed on Indonesia Stock Exchange during the period of 2015 - 2017. In conclusion, writer came up with the title of "**THE IMPACT OF GENDER-DIVERSE MONITORING PERSONNEL ON FINANCIAL REPORTING QUALITY**"

1.2 Research Problem

Based on background presented above, it is known that the quality of financial reporting is important for financial statement users in their decision-making process and the composition of monitoring personnel is considered one factor that might affect it. Said information will be obtained through gender diversity in the monitoring composition. To achieve expected target, the research problem for this research is "Does gender diversity in monitoring personnel have an influence towards the financial reporting quality?"

1.3 Research Objective

This research is done to obtain empirical evidence and prove empirically that gender diversity in monitoring personnel does have an effect on the financial reporting quality.

1.4 Significance of the Study

a. For Corporation

   Hopefully, this study could be useful for decision-making processes and could contribute to framework regarding practice related to corporate governance, specifically effect of monitoring personnel characteristic to financial reporting quality. The findings of this study hopefully will bring better insight or new perspective to the companies regarding the gender equality in corporate boards or even in general. By knowing the impact of gender-based differences of the monitoring personnel on financial reporting quality, it will assist the company in the recruitment or selection process of corporate personnel, to consider and decide whether corporation should only hire male employee, also consider what is the potential advantage and disadvantage of having female on board.

b. For Next Researcher

   The result of this study hopefully would be able to provide additional knowledge, unfold new perspective, and provide useful information for future studies related to factors affecting financial reporting quality, as well as studies that involve the topic of gender diversity in corporations.

c. For Regulatory

Hopefully, this study could contribute as a literature consideration for the government to improve or re-establish law and standards regarding quality of financial reporting of a company. The results of this study may be helpful to policymakers to verify the usefulness of policies related to the promotion of diversity on corporate personnel and to motivate regulators to take additional actions to promote a greater gender balance in general.

d. For UPH (Universitas Pelita Harapan)

The result of this study hopefully may give additional information about the application of theories that are taught during the process of learning, as well as additional consideration of depth of material to be taught in the process of learning at class.

e. For Literature Reference

Taking into account that there aren't many studies that discuss the very topic regarding the impact of gender diversity towards financial reporting quality, the result of this study hopefully is able to contribute to literature or research regarding the topic of financial reporting quality in Indonesia. Especially in the area of the factors influencing the financial reporting quality.

1.5 Scope of the Study

a. This research examines only 1 independent variable which is gender diversity in monitoring personnel as represented in board of commissioner, in audit committee, and in external auditor.

b. This research examines moderating variable which is gender diversity in board of director.

c. This research focus only on manufacturing industry which are listed on the Indonesia Stock Exchange.

d. Research limits the observation to a period of 3 years, which is 2015-2017.

1.6 Systematic Discussion

The research paper is systematically divided into five chapters as follows:

CHAPTER I **INTRODUCTION**

This chapter will discuss subchapters that include background, research problem, research objective, significance of the study, scope of the study, as well as systematic discussion.

CHAPTER II **THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT**

This chapter will first discuss in detail the basic concept definitions and theories that help explain and support this research study. It will also include literature review, conceptual framework, and the hypothesis development.

CHAPTER III **RESEARCH METHODOLOGY**

This chapter will explain in detail what method of research is being used. This includes the population and sample, the empirical model, operational variable definition, and method of data analysis.

CHAPTER IV **RESULTS AND DISCUSSION**

This chapter will discuss the result and empirical findings in the research in relation to the impact of gender-diverse monitoring personnel on the financial reporting quality.

CHAPTER V **CONCLUSION AND RECOMMENDATION**

This chapter consists of conclusion and suggestion from the result, as well as recommendations for future researches.