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THE EFFECT OF BOARD OF COMMISSIONERS, AUDIT COMMITTEE, AND INTERNAL AUDITOR ON FINANCIAL REPORTING QUALITY OF BANKS LISTED ON THE INDONESIA STOCK EXCHANGE

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Abstract

This study concerned the census of 22 banks that are listed on the Indonesia Stock Exchange in 2012. There were four state-owned banks and 17 foreign exchange banks and non-foreign exchange banks. This study aims to determine the partial and simultaneous effects of corporate governance mechanism, which consists of a Board of Commissioners, Audit Committee, and Internal Auditor, on the Quality of Financial Reporting. The research hypothes is tested using a path analysis. The results showed that: (1). Partially: (a) The Board of Commissioner has carried out its functions effectively and gives a positive effect as much as 25.37% to the increased quality financial reporting. (b). Audit Committee gives a positive effect as much as 19.35% to the quality offinancial reporting (c). Internal Auditor gives a positive effect as much as 30.41% to the Quality of Financial Reporting. (2) Simultaneously, corporate governance mechanism which consists of the Board, Audit Committee, and Internal Auditors gives a positiveeffect as much as 75.13 % to the financial report quality. While the remaining 24.87% positive effect is influenced by other factors which are not examined in this study, such as the quality of the External Auditor or the work culture of the organization. The mechanism Implementation of corporate governance of the banks listed on the Indonesia Stock Exchange has been effectively implemented to improve the quality of financial reporting.

Keywords: Corporate governance mechanism, Board of Commissioner, Audit Committee, Internal Auditor, Quality of Financial Reporting

INTRODUCTION

The financial crisis that hit the world, especially in Asia over the last decades has brought Indonesia into downfall and an uncertain economy. Many giant companies in real estate and services experienced financial crisis. These were triggered by a poor corporate governance at that time because of inconsistency in implementing good corporate governance. It caused many companies, especially banks, experienced liquidity due to the credit failure that was caused because the banks did not follow the rules for making good loans. Violations of the principles of good corporate governance in banking corporations are the effects of the minimum banking regulations concerning rights and obligations of the parties related to the company such as: shareholders, board of commissioners, board of directors and, internal watch dog units. Therefore, this study will examine the effect of corporate governance(CG) mechanism on the quality of financial reporting in the bank slisted on the Indonesia Stock Exchange(IDX). Corporate governance mechanism is proxied by the variables of Boardof Commissioners, Audit Committee, and internal auditor. Corporate Governance(CG) refers to the relations among various participants in the corporation that determine the direction and performance of the corporation (Monks &Minow, 2001). The issue of CG has come to the surface, especially in Indonesia, after Indonesia's prolonged crisis period, which began in 1998. Many said that the long duration of the repairing process in Indonesiais due to the very weak CG applied to Indonesian corporations. Since then, both government and investors began to give significant attention to CG practices.

Daily & Dalton (1994) examined the possible relationship between the two aspects of governance structure-Board composition and leadership structure, as an explanatory factor of the bankruptcy of the corporation. Their study concluded that there was a significant relationship between the Board composition and leadership structure with a possibility that the corporation went into bankruptcy as the result of poor quality financial reporting. Hambrick & D'Aveni (1992) also proved that a dominant CEO is more likely correlated to the corporation's bankruptcy than a less-dominant CEO.

The application of accounting conservatism in financial reporting aims to recognize, measure and report the value of assets and a low income and, high value for liabilities and expenses. In some accounting theory literature, "pessimism concept" is considered to be better than excessive optimism. (Wolketal., (2001), mentioned that conservatism as a preference for accounting methods that produce the lowest value for the assets and incomes, while the highest value for the debt and costs, and producethe lowest book value of equity. The Implication of the conservatism concept in accounting principlesis that accounting recognizes expenses or losses that might occur, but does not immediately recognize revenue or profits that will be earned even if most likely it will happen (Suwardjono, 1989). Furthermore, to measure the quality of financial reporting, Financial Accounting Standards (GAAP, 2009) establishes the qualitative characteristics which should be included in accounting information to be used in the decision-making process. Hedriksen and VanBreda(2000) suggested some qualitative characteristics that must be included in financial reports ,namely *cost and benefit, Relevance, Reliability, Comparability, and Materiality*. Accounting information is relevantif it can affect a decisionby strengthening or changing the expectation of decision makers, and that information is reliable if it is credible and it leads consumers to rely on it. To be useful, information must also bereliable. The Information is reliable if it does not contain a misleading sense, material errors, and people can count on this information as a faithful representation of what should be presented or reasonably expected to be presented (SAK, 2009).

The unrealible accounting information, that led to the fall of the world's giant corporations in the early decades of 2000s as a result of scandal legal accounting manipulation cases which involved large corporations that conducted earnings management, has led to some accounting reporting scandals that are widely known, such as:Enron, Merck, WorldCom and the majority of other companies in the United States (Cornett etal., 2006; Siswanto &Aldridge, 2005). In the case of Enron, for example, the impact was very obvious, investors had to bear the loss caused by the dramatic collapse of the stock value (from U.S. $30 to U.S.$ 10 per share) in two weeks time. There was a big question: How could such thing happen to aworld-class corporation and made them declare bankruptcy even after the corporate financial audit stated that Enron was “normal and healthy" (Alijoyo, 2003). In Indonesia, the financial Report manipulation scandals involved LippoandKimia Farma. Those scandals were revealed after a manipulation had been detected (Gideon, 2005). The Lippo’s multiple financial report scandal or Lippogate was considered as avery serious scandal because it involved not only private, but also government institutions, such as BPPN, Bapepam, The Indonesia Stock Exchange, and Bank of Indonesia(BI). Lippogatewas begun when there was a case of multiple financial reports which were all categorized as "audited" by LippoBankin September 2002 and December 2003. This phenomenon indicates that a financial scandal is a failure of the financial report integrity in providing the information needed by users. Earnings as part of the financial reports do not present the actual facts about the economic conditions of the company, therefore, earning that is expected to provide information to support the decision-making, its quality becomes questionable (Gideon, 2005). According to the *StatementofFinancialAccountingConcepts (SFAC) No.1,* the earnings information is of great importance in assessing the performance and responsibility of the management. In addition, earnings information also helps the owner or other partys in estimating earnings power of the company in the future. In Mayangsari study (2003), the quality of financial report is defined as follows: "The quality of the financial report is the extent to which the financial reports show faithful and trustable information. "Meanwhile, according to the StatementofFinancialAccountingConcepts (SFAC) No.2: the quality of information that assures that information is reasonably free from error and bias and honestly presents what is meant to be revealed. There are two measuring instruments of financial reportquality. First, financial report quality is measured by conservatism while financial statement manipulation is usually measured by earnings management.

A financial report is one of the information sources thatis formally required to be published as a means of management's accountability to natural resource owner management. Publication of a financial reportas a product of accounting information produced by the company is closely related to the drafting process. The process of preparation of thefinancial statements involves the board of the management. To assess the quality of financial reporting that is presented, the role of the board of commissioners in a public company is to supervise and ensure good corporate governance(GCG) to generate the integrity of good quality financial reports.

The reduction of the integrity of financial report information has triggered the collapse of the major companies mentioned above, due to the many cases of auditors, who audited the corporation's financial report company and they donot work directly under audit committee's supervision and are not free from the influence of seniormanagerial interests of the company (CEO, Board of Commissioners, Committee audit, and Internal Auditor), (Siswanto & Aldridge, 2005).

To ensure the integrity of financial report information, it is the board of commissioners's responsibility to set up the company's audit committee, as required by the National Committee on Good Corporate Governance (KNGCG, 2002) : the audit committee has an important role in overseeing the various aspects of the organization.

In 2001, Indonesian government created a regulation about a necessity of public companies to have independent directors and audit committees (PEM 339/BEJ/07-2001). Since 2002, therefore, a great deal of research on the influence of independent directors and audit committees has been conducted.

LITERATUREREVIEW

Ahmed and Belkaoui (2000) outlined the importance of earnings information for the parties concerned, firstly, it is because corporations make earnings as a basis in determining dividend policy. Secondly, The corporation' taxliability is based on the corporate' profit . Thirdly, earnings is considered as a guide in determining the direction of investment by economic decision-makers. Fourth, Earnings is believed to be means of prediction that assists in predicting earnings and economic events in the future. Fifth, profit becomes a guideline for measuring management performance. According to the legal cases of earnings management of public companies in Indonesia which are exposed to legal action, intuitively we can conclude that the low quality of financial reporting becomes one of the causes of public companies receiving legal sanction (Mayangsari, 2003). As a result of investigation in 2002, many violations were found. It was indicated by a number of cases handled by Bapepamare under the investigation process.In the examination phase, Bapepamhandled 43 cases. They successfully completed 33 cases and 10 cases are still under investigation. Two cases were brought upto high-level investigation. These cases are still in the process of filing to later be handed over to the Prosecutor (Press Releases Year-End Capital Market Supervisory Agency, 2002). Most enforcement actions are caused by financial report violations such as: being late in submitting financial reports, giving in-actual financial information, conflict of interest, disclosure, market manipulation and,a disclaimer opinion of the auditor, the Auditor Industry Specialization and AuditQuality.

Financial reports become a company's major tool to submit financial information regarding the management accountability (Schipper and Vincent, 2003). The conceptual framework of *Financial Accounting Standards Board(FASB No.2)* states that the objective of a financial report is to provide useful information for business decisions. Meanwhile, SAK (2004) states that the purpose of financial reports is to provide some information regarding the financial position, performance and changes of a company's financial position that is useful for a large number of users in making economic decisions. Statement *of FinancialAccountingConcepts (SFAC) No. 1 (1978)* states that financial reports should provide useful information for the current investors and creditors and can be used to make investment decisions, credit, and ot her similar decisions. Corporate governance also provides a structure that facilitates the determination of a company's goals, and as a facility to determine performance monitoring techniques (Dean etal., 2004). Accounting-based performance is the performance of corporate finance, so it is said that corporate governance can affect company's profitability level. According to BergeandRidder(1999), in Deanetal., (2004) it is not easy to connect company performance to good corporate governance. Actually, the concept of corporate governance is not a new thing. This concept has existed and evolved since the corporation concept was introduced in the United Kingdom in the middle of the nineteenth century (Solomon &Solomon, 2004). The purpose of corporate governance is "to create added value forall stakeholders." . The definition of *corporete governance* according to the Australian *Stock Exchange* (ASX) in (Siswanto & Aldridge, 2005), *Corporate governance is the system by which companies are* *directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimized.* Meanwhile, according to Solomon and Solomon (Siswanto & Aldridge 2005), Corporate Governanceis to govern the relationship between companies (represented by Board of Directors) and shareholders. Corporate Governance also regulates relations and corporate responsibility or accountability to all members of the non-shareholder stakeholders.

According to Baridwan, (2003) in NdaruningpuriWulandari, (2005), and Siswanto & Aldridge, (2005), the basic principles of corporate governance in the implementation of good corporate governance practices are *fairness, responsibility, accountability and transparancy.*

THE EARLIER RESEARCH

The Research considering the influence of corporate governance mechanisms (institutional ownership, independent directors and audit committees) on the application of accounting conservatism in a company still showed inconsistent results. According to Lins and Warnock (2004) in Hapsoro (2006), in general the mechanism that controls management behavior or often called corporate governance mechanisms can be classified into two groups. The first mechanism is an internal mechanism which consists of firm-specific ownership structure and management structure. Both are state-specific external mechanisms that consist of law and corporate control market. Balletal., (2000) in Wibowo(2002) states that the choice of an accounting method related to conservatism principles, which are influenced by ownershipstructure, is one of corporate governance mechanisms. Rossetal., (1999) in Tarjo(2002), states that there is a tendency that the bigger the proportion of management ownership, the harder the management will workin the interest of shareholders to enhance shareholder value by applying accounting conservatism. Faisal's research results(2005), indicates that institutional ownershipis not effective as a variable to monitor the management in improving corporate value through the increasing of asset turnover and reducing operating expenses. Sharma's research (2004) examined the influence of the Boards of commissioners characteristics and institutional ownership against fraud. One of the independent variables used was the percentage of one company's managerial ownership. The results indicated that managerial ownership has no statistically significant effect on the existence of fraud in the company. The other research related to the independent commissioner is Uzunetal., (2004). The research examined various characteristics of the Board of commissioners and completeness of governance that influences the possibilities of fraud in American companies during the period of 1978-2001. The study showed that companies tend to lower the percentage of independent commissioners fraud. Frauds caused the declining of a company's value, and resulting indecreased bond ratings and increased bond yields. Evansetal., (2002) in Setyapurnama, (2005), showed that the ratio of independent directors is negatively related to corporate performance. While Fuerst and Kang (2001) showed there was a positive relationship between the independent directors and corporate performance. Vafeas (2000) stated that, the role of the board of commissioners are not only as managerial owners but also is expected to improve the earnings quality by limiting the level of earnings management through the monitoring function over financial reporting. Monitoring function performed by the board of commissioners is influenced by the its size.

Cotter and Silvester (2003) focused on the composition of the supervisory board of commissioners and committees in Australian companies. This study proves that there is a positive relationship between the proportion of independent directors and the supervisory committee in the companies' performance with multiple regression analysis.

Mayangsari (2003) noticed a negative relationship between audit committees and financial reporting quality that reflects the company's performance. This suggests that the existence of audit committees are less effective in improving the performance of the company. She also proved that the independent commissioner gave negative effect to the quality of financial reporting. It proved that the independent commissioner does not affect the quality of financial statements which is the reflection of the company's performance.
The results of other studies related to the mechanisms of corporate governance with the quality of financial reporting are asfollows:

Table1. The Earlier Research

NO	TITLES	AUTHOR/ YEARS/ PUBLICATIONS	PREMISE/SUMMARY
1.	THE CORPORATE GOVERNANCE MOSAIC AND FINANCIAL REPORTING QUALITY	Jeffrey Cohen; Ganesh Krishnamoorthy; Arnie Wright *Journal of Accounting Literature;* 2004; 23, ABI/INFORM Global pg. 87	In summary, Figure 1 depicts the actors in the governance process, highlights their potential interactions, and suggests that the governance process impacts the quality of financial reporting (e.g., transparency, objectivity) and, in the extreme, earnings manipulation and outright fraud.
2	CORPORATE GOVERNANCE AND FINANCIAL REPORTING QUALITY: THE CASE OF TUNISIAN FIRMS	Abdelwahed Omri Institut Supérieur de Gestion de Tunis, University of Tunis International Business Research Vol. 4, No. 1; January 2011	The results reveal that the governance mechanisms affect the financial information quality of the Tunisian companies.
3	CORPORATE GOVERNANCE AND THE TIMELINESS OF FINANCIAL REPORTING: AN EMPIRICAL STUDY OF THE PEOPLE'S REPUBLIC OF	Robert W. McGee, Florida International University Xiaoli Yuan, California State University, East Bay Working Paper May 2008	Those results were then compared to data of non-Chinese companies in developed market economies to determine whether there was a significant difference. This study also examines which independent audit firms issued the audit opinion and which sets of accounting standards were used (IFRS, US GAAP or Chinese accounting

	CHINA		standards) to determine which audit firms and accounting standards dominate.
4	EVIDENCE ON THE RELATION BETWEEN CORPORATE GOVERNANCE CHARACTERISTICS AND THE QUALITY OF FINANCIAL REPORTING	ARTHUR LEVITT, Chairman Securities and Exchange Commisiion. SSRN	This paper presents the first direct evidence of the relation between corporate governance characteristic and financial reporting practices. The most significant findings are the negative correlations between the presence of insiders and so called grey area directors on the audit committee and two measures of the quality of financial reporting practices
5	BOARD MONITORING, AUDIT COMMITTEE EFFECTIVENESS, AND FINANCIAL REPORTING QUALITY: REVIEW AND SYNTHESIS OF EMPIRICAL EVIDENCE	Luo He, Réal Labelle, Charles Piot Daniel B. Thornton *Journal of Forensic & Investigative Accounting, Vol. 1, No. 2, July-December 2009*	we conclude that board independence is the most effective deterrent of fraudulent financial reporting
6	AUDIT COMMITTEE, BOARD OF DIRECTOR CHARACTERISTICS, AND EARNINGS MANAGEMENT	April Klein Journal of Accounting and Economics Volume 33, Issue 3, August 2002, Pages 375-400	A negative relation is found between audit committee independence and abnormal accruals. A negative relation is also found between board independence and abnormal accruals. These results suggest that boards structured to be more independent of the CEO are more effective in monitoring the corporate financial accounting process.
7	AUDIT COMMITTEE CHARACTERISTICS AND THE PERCEIVED QUALITY OF FINANCIAL REPORTING: AN EMPIRICAL ANALYSIS	Andrew J. Felo School of Graduate Professional Studies Srinivasan Krishnamurthy Binghamton University - School of Management Steven A. Solieri University of Scranton - Kania School of Management State University, Working …, 2003 - papers.ssrn.com	We also find some evidence of a positive relationship between the size of the audit committee and financial reporting quality
8	THE EFFECTS OF INTERNAL AUDIT REPORT DISCLOSURE ON PERCEIVED FINANCIAL REPORTING RELIABILITY	Travis P. Holt The University of Alabama Culverhouse School of Accountancy F. Todd DeZoort The University of Alabama Culverhouse School of Accountancy December 2006	This study reports the results of an experiment that examines whether investor confidence in financial reporting reliability is increased by the disclosure of an IAR. The results indicate that increased transparency about the internal audit function significantly increases nonprofessional investor confidence that the financial information is free from both intentional and unintentional material misstatements.
9	ACCRUALS QUALITY AND INTERNAL CONTROL OVER FINANCIAL REPORTING	Jeffrey Doyle, Weili Ge, Sarah McVay January 24, 2007 *The Accounting Review, forthcoming*	We examine the relation between accruals quality and internal control quality and find that firms with weak internal control over financial reporting generally have lower accruals quality.

FRAMEWORK AND HYPOTHESES

To obtain further empirical results about the effect of corporate governance mechanisms to the quality of financial information and other factors that may affect the relationship. Johnsonetal., (2000) in Susiana and Herawaty (2007) provided evidence that low quality of corporate governance's in one country has a negative impact on the stock market and currency exchange rate of the country during the Asian crisis. In addition Ohnson also defined *corporate governance* as the mechanism effectiveness that aims to minimize the effectiveness of the agency conflict. Beaslyetal., (1996) in Susiana and Herawaty (2007) stated that companies that implement good corporate governance will tend to increase their performance.

The Board of Commissioners and Financial information Quality

Having different roles between shareholders as principals and managers as agents, a manager will ultimately has a significant controlling interest in terms of how they allocate investors' funds (Jensen &Meckling, 1976; Shleifer &Vishny, 1997). Additionally Mizruchi (1983) also explained that the Board is the center of control within the company, and the Board is the major responsibility for the level of health and long-term success of a company (Louden, 1982).

The Board of commissioners is focused on the monitoring function of the director's policy implementation. The role of commissioners is expected to minimize the agency problems that arise between the board of directors and shareholders. Commissioners, therefore, should be able to oversee the company's financial information processs.

A Previous research states that a company with large board of committee can not conduct better coordination, communication, and decision-making than a company with a small board of committee. These make the difference in company's value. A company with a bigger-sized board has lower value than the other (Jensen, 1993; LiptonandLorsch, 1992; Yermack, 1996). The Board of Commissioners is one of the most important mechanisms incorporate governance. Bank of Indonesia RegulationNUMBER8/4/PBI/2006 on the Implementation of Good Corporate Governance for Banking, explains that Board of commissioners and independent commissioners as its members. BI regulation requires that the number of commissioners consits of least three or, a maximum of as many as the number of directors. The Board of Commissioners is expected to determine the quality of good financial reporting.

Before they are appointed as commissioner members, they must pass fit and proper tests and carry out their activities according to the applicable rules and duties. The Board of commisioners must ensure that directors follow upthe audit findings and the recommendation from the Bank's internal audit unit, the external auditors, the results from the supervision of Bank Indonesia and/or the results of other supervisory authoritiess of that the quality of financial reports is according to the rules.

This research is focused not only on size, but also the composition of the board of commissioners which must assess the independence of independent directors, who are also members of the board of commissioners. There is a different need of the numbers and composition of the board of commissioners between a company which has a financial problem and a company which has a good financial condition.

One of the problems in the application of corporate governance is that there are CEOs who have greater power than the board of commissioners. Where as the functions of the commissioners are to supervise the performance of directors' duties and responsibilities of directors, as well asto advise the board of directors, led by the CEO. Research on the impact of board independence on the quality of financial reporting is also stated by Luo H, RealLabelle, CharlesPiot & DanielB.Thornton (2009) that council's Indenpendecy will be very effective in preventing fraud and financial reporting frauds. The context of this independence becomes more complex in a company with financial problems. Independent commissioners generally have better controlon the management, thus, it can reduce the possibility of fraud in presenting the financial reports madeby management (Chtourou, et al. 2001). The existence of independent directors should be completely independent and can resist the effects of interventions and pressure from main shareholders (Weisbach, 1988 in Arifin, 2005).

Fama and Jensen (1983) stated that non-executive directors (independent directors) can act as a mediator in the disputes among internal managers and oversee management policies and provide advice to management. Independent commissioners play an active role in reviewing financial reporting policies and practices that can affect the quality of financial reporting, especially regarding the timeliness of a company's financial reporting..

H1: The Board of Commissioners give a positive effect on Financial Reporting Quality

Audit Committee and Financial Reporting Quality

The audit committee is a committee that is established by the board of commissioners. It is established to carry out an independent monitoring of the financial reporting process and external audit. In terms of financial reporting, the role and responsibilities of the audit committee are to monitor and oversee financial report audits and ensure that financial policies and standards and to verify whether the financial statements are in accordance with the standards and policies and to verify the consistentcy of it with other information known to the audit committee members, as well as to assess the quality of service and cost reasonableness proposedby external auditors (KNGCG, 2002).

Duties and Responsibilities

Audit Committee is established as a special committee to optimize the control function which previously was the sole responsibility of the Boardof Commissioners. A Circular Letter of Indonesia Stock ExchangeNo.SE-008/BEJ/12-2001datedDecember 7, 2001 announces a membership of external auditors as audit committee members. The role of the Audit Committee is issued in BAPEPAM circular letter SE-03/PM/2002. It states that the Audit Committee is composed of, at least, 3 persons, chaired by a company's independent commissioner with the proportion of 30% for the implementation of good corporate management. The Audit Committee is responsible to the Board of Commissioners for the implementation of the tasks that have been determined and they must make a report to the Board for any givenuse (JSE, 2001).

Independency

Siegel (1996) stated that the audit committee is an instrument that is set up within the client's company. The Audit Committee is set to maintain the independence of the management accountant examiner. Supriyono (1998) stated that the audit committee has a function to provide point of views on financial policy, accounting and internal control issues. Klein (2002), provided empirical evidence that a company with an independent audit committee, report company earnings that contain smaller discretionary accruals compared to companies that do not have an independent audit committee. The content of the discretionary accruals is related to company's earnings quality. Price Waterhouse (1980), in McMullen (1996), states that investors, analysts and regulators assume that an audit committee contributes to the quality of financial reporting. The audit committee improves the integrity and credibility of financial reporting by the board of commissioners. Members of the audit committee are required to forman independent external audit company and, should consist of independent individuals who are not involved with daily tasks of management for the company they are auditing and, have the experience to accomplish their oversight functions effectively. One of the main reasons for this independence is to maintain integrity and objective views in the preparing a report and recommendations made by the audit committee. These individuals tend to be more independent, fair, impartial and objective in dealing with a problem (FCGI, 2002).

Knowledge and Expertise

Audit committee should have adequate abilities in understanding accounting, auditing and a company's' system as well asanalyzing financial reports. Competence of the audit committee is embodied in the financial expertise of the committee members. Andrew J. Felo et al (2003) found evidence that there is a positive relationship between financial expertise and financial reporting quality. The existence of the Audit Committee members who have the ability or experience in accounting or finance is required by the Bank of Indonesia's regulations in the implementation of good corporate governance for Commercial Banks. Parker and Peters (2002), in studying the characteristics of the audit committee concerning financial fraud and misstatements discovered that financial misstatement is positively related to the lack of knowledge in accounting and finance.

H2: The audit committee gives a positive effect on the Financial Reporting Quality

Internal Audit and Financial Reporting Quality

A close relationship between internal auditor and audit committee has the potential to improve the corporate governance of both parties. The independence of internal auditors will be stronger when the information is submitted directly to the audit committee and is not hampered the concern that the information will be leaked compared to the Internal Auditor information that is directly reported to management.

Furthermore, the existence of an internal auditor will be required if it is an important part of the audit committee. Accordingly, the effectiveness of the Audit Committee (AC) is strengthened when it is able to maximize the resources or internal auditor (IA) staff to obtain significant information on issues such as the strength of the company's internal controls and the quality of accounting policies.

Much of the research on this issue employs a survey methodology to examine the effect of audit committee (AC) characteristics of the internal auditor. Scarbrough et al. (1998) conducted a survey of internal auditor officer (IAO) and found a positive association between audit committee independence (AC) and the frequency of meetings with the chief internal auditor (CIAS) as an internal auditor in reviewing auditor internal workt hat impacts on the quality offinancial reporting.

Raghunandan et al. (2001) discovered that when the chief of the internal auditors has a meeting with the audit committee more often, they will reach a recommendation regarding the independence and oversight of financial reporting that suits with the BlueRibbon. Goodwinand Yeo (2001) also discovered that audit committee should do more meetings either personally or institutionally with the internal auditors.

The review of financial reports which are related to financial audit work, consists on average 25 percent of the work, is usually done by internal auditors (Felix et al. 1998). Monitoring activities which are carried out by internal auditors serves an important function to ensure the quality of financial reporting (BRC 1999). The role of internal auditors in financial reporting will be increased when the external auditors rely on the workof internal auditors to complete financial report audits (for example, see AICPASASNo.65; Maletta and Gramling 1999). In planning and conducting an audit on integrity and reliability of the financial information, internal auditors are always directed to be alert of anything that could be fraudulent. Two areas with the potential for fraudulent financial reporting, that can be identified in previous research, are the management's incentive to misstate their financial position (Loebbecke et al. 1989) and the quality of corporate governance mechanisms, especially the audit committee, which is designed to limit the chance of false financial reporting (Beasley et al 1999). Numerous articles have been published by many practitioners who discuss the important role of internal audit in the merger and acquisition process (eg, Nygaard 2002; Aldhizer and Cashell 1999, 2000).

Chtourou et al. (2001), furthermore, the IIA standard emphasizes that it is important to have an appropriate audit plan, in order to discover the risks in false financial reports, (IIA, 2001 Part 1220.A1). Incentive to commit fraud in financial reporting is influenced by management incentives, which motivate management to provide incorrect financial information (Loebbecke, Eining, and Willingham 1989). These incentives arise in financial reporting from a variety of sources, including the commitment to achieve unrealistic analyst's forecasts, management bonus plans based on financial performance, and a perceived need to continue the trend of sales growth (AICPA 2001; Duncan 2001; Jacksonh and Pitman 2001). Internal auditors have an assignment to conduct rigorous and continuous oversight in maintaining the integrity of the financial reports in the financial reporting process so as to narrow the fraud activities so that the information given and made by the company according to the company's position.

H3: Internal Auditor gives a positive effect on Financial Reporting Quality

RESEARCH METHOD

Variable Operationalization

Variable operationalization aims to reveal the variables of a problem into the smallest parts so that the size classification can be discovered. In this study, the author uses two types of research variables .They are independent variables or variables that give effects and the dependent variable, variable that is affected.

Based on the above statement, Corporate Governance Mechanism (X) is a variable that gives effects, while Quality of Financial Reporting variables is a variable that is affected (Y). Each variable is described as; *Mechanism of Corporate Governance* (Variable X) includes all the actors that play a role in corporate governanceimplementation so as to achieve a more transparent corporate management for financial statement users. *Quality of Financial Reporting* (Variable Y) consists of some process .

Table 2 Variable Operationalization

Variable	Dimension	Concepts	Indicators	Measures
Corporate Governance Mechanism (X)	**Board of Commissioners (X1)**	Board of commissioner is a council that is tasked to supervise the performance of duties and responsibilities of management (Rule of BANK of INDONESIA8/4/PBI/2006)	▪ Commissioners proportion ▪ Board size ▪ Management Oversight ▪ Duties & Responsibilities of the Board ▪ The intensity of the Board ▪ Board Transparency	•Proporsition level of independent commissioners. •Size Level of commissioners •Oversight Management level •Duties & responsibilities level •Number of meetings level •Transparency level
	Audit Committee (X2)	A committee that is established by the Board of commissioners and is responsible to board of commissioners with its primary duty and responsibility to ensure the principles of good governance, especially transparency and corporate disclosure that is consistent and adequately applied by the executive (Tjager et al, 2003)	▪ Audit Committee Structure ▪ Roles and Responsibilities ▪ Independency ▪ Audit Committee's knowledge ▪ Audit Committee's expertice	•The level of committee structure •Level of audit committee roles • level of audit committee's responsibilities •Level of Indenpendence •level of audit committee's knowledge • level of audit committee 's expertise
	Internal Auditor (X3)	Internal auditis an examination conducted, both on the company's financial statements and accounting records , and adherence to the top management's policies that have been defined and adherence to government and the applicable terms of the professional associations (Sukrisno Agoes, 2004:221)	▪ Professionalism ▪ Independence ▪ Competence ▪ experience	•level of professionalism •Level of Indenpendence •Level of Competence •level of internalauditors' experience.

Financial Reporting Quality (Y)	Financial reporting includes financial report, also other ways of communicating related information, directly/ indirectly, that is provided by the accounting system which is informati on about resources, obligations, corporate income (Belkaoui, 2006).	▪ Relevance ▪ Faithful ▪ representation ▪ Understandability ▪ Comparability ▪ Timelines	•Level offinancial report relevance •Level of financial report clarity •level offinancial statement understanding •Level ofcomparison •level ofpunctuality

Population and Research Sample

Population is the entire group ofstudy subjects, which in this case are the banks that are listed on the Indonesia Stock Exchange. Therefore, the analyses unit consists of 22 banks-owned banks, foreign banks, and non-foreign exchange banks. Related to the primary data collection, the author defines the research respondents as follows:

Table 3 Population Respondents

Respondents	Board of Commissioners (X1)	Audit Committee (X2)	Internal Auditor (X3)	Financial Reporting Quality (Y)
Board of Commissioners	23	23	-	23
Directors	31	31	31	-
Audit Committee	22	22	22	22
Internal Auditor	-	28	28	28
Division Heads	71	-	71	71
Total	147	104	152	144

Data Collection Tool

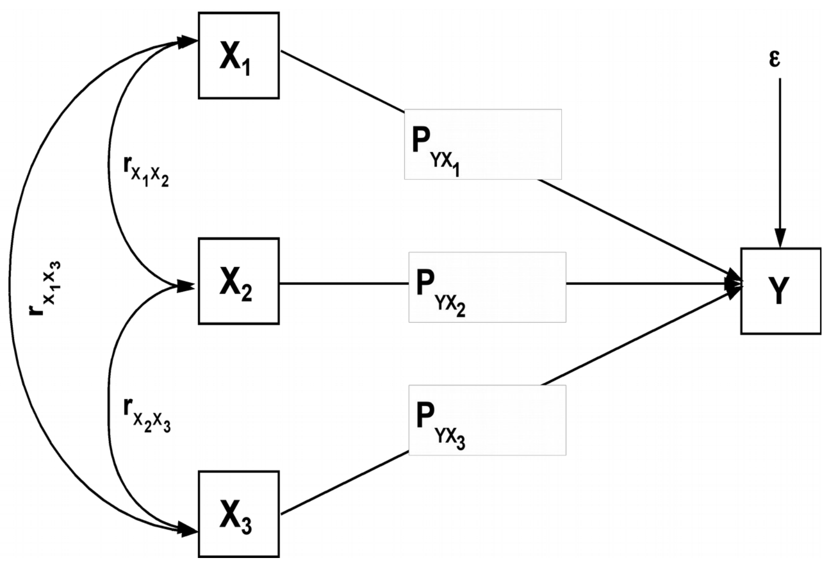
Questionnaire consists of 62 items that are divided into 12 statements about the functions of Board of commissioners, 13 statements regarding the function of the audit committee, 16 statements regarding the function of internal auditor and 21 statements about financial reporting quality.

This questionnaire was subject to validity and reliabilty check using prescribed statistical approaches.

Data Analysis Tool

Through analysis method, We will explain about the research instrument testing (validity and reliability), data transformation (method successive interval), data analysis tools, and hypothesis testing. Data analysis tool that is used in this study using path analysis with the following path structure:

Figure 1: Diagram Structure of Path Model Research



Descriptions:

X1: BoC

X2: Audit Committee

X3: Internal Auditor

yx1: parameters that describe the structure of the strong influence of X1 on Y.

yx2: parameters that describe the structure of the strong influence of X2 on Y.

yx3: parameters that describe the structure of the strong influence of X3 to Y.

rx2x1: correlation coefficient that describes the relationship between X1 and X2.

rx3x1: correlation coefficient that describes the relationship between X2 and X3.

Y: The parameter that describes the structure of the strong influence of other factors on Y.

ANALYSIS AND RESULTS

Research Questionnaire Validity Testing

The test wasconducted to determine the validity of the measuring instrument which was designed in the form of questionnaires. As noted in the research methodology, to test the validity of the measuring instruments, we used statistical approach through the value of the correlation coefficient score of the statement with the total score.

If the correlation coefficient of the statement with a total score of ≥0.30, the statement is valid. Based on the moment correlation (validity index) test, the result is as follows;

Table 4 Questionnaire Validity Test on the function of Board of Commissionares

Statements	Validity Index of The Board of Commisioners Function	Validity Index of Audit Committee Function	Validity Index of Internal Auditor Function	Validity Index of Financial Reporting Quality	Critical value	Descriptions
Item 1	0.938	0.906	0.800	0.679	0.30	Valid
Item 2	0.727	0.549	0.652	0.533	0.30	Valid
Item 3	0.658	0.628	0.553	0.752	0.30	Valid
Item 4	0.820	0.860	0.510	0.545	0.30	Valid
Item 5	0.670	0.645	0.604	0.615	0.30	Valid
Item 6	0.929	0.914	0.729	0.686	0.30	Valid
Item 7	0.592	0.572	0.525	0.530	0.30	Valid
Item 8	0.891	0.859	0.555	0.713	0.30	Valid
Item 9	0.714	0.509	0.541	0.585	0.30	Valid
Item 10	0.933	0.894	0.569	0.625	0.30	Valid
Item 11	0.938	0.925	0.539	0.741	0.30	Valid
Item 12	0874	0.733	0.746	0.604	0.30	Valid
Item 13	-	0.769	0.799	0.834	0.30	Valid
Item 14	-	-	0.566	0.800	0.30	Valid
Item 15	-	-	0.778	0.682	0.30	Valid
Item 16	-	-	0.646	0.731	0.30	Valid
Item 17	-	-	-	0.526	0.30	Valid
Item 18	-	-	-	0.751	0.30	Valid
Item 19	-	-	-	0.805	0.30	Valid
Item 20	-	-	-	0.683	0.30	Valid
Item 21	-	-	-	0.891	0.30	Valid

From the four tables above ,we can see the validity index of each statement is larger than the critical value of 0.30. It can be concluded that the entire statement items, that are used to measure the four variables, are valid so it can be used for further analysis.

Reliability Testing

Measuring instrument requires not only validity but also reliability. A measuring instrument can be reliable if the instruments give relatively similar results (not much different) when they are used many times. To view the reliability of a measuring instrument, statistical approachment is held, through the reliability coefficient.If the reliability coefficient is larger than 0.70 ,the whole statement is considered to be reliable. Based on the results of processing through alpha-cronbach, the reliability test results obtained are as follows:

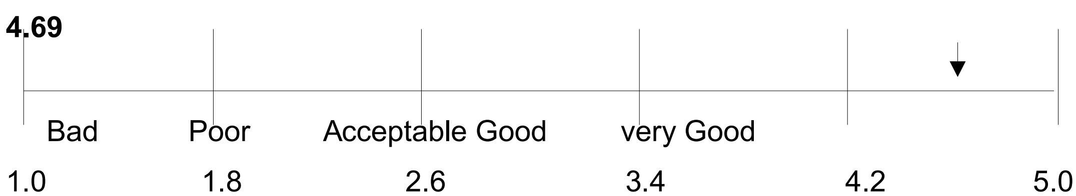
Table 5 Realitbity test of research Questionaers

Quesioner	**Realibility Coefficient**	**Critical Value**	Description
Board of Commissioners Function	0.972	0.70	Reliable
Audit Committee Function	0.940	0.70	Reliable
auditor internal Function	0.891	0.70	Reliable
Financial Reporting Quality	0.930	0.70	Reliable

Functions of the Board of Commissioners

The function of the board of commissioners of banks listed on the Indonesia Stock Exchange will be revealed through respondents' answers to the statements in the questionnaire. The average Score of Respondents' Answers Regarding the function of Board of Commissionire function is presented in the figure 2 (results of data processing) as follows:

Figure 2 Scale of Average questionnaire interpretation Score on the Function of The Board of Commissioners



Functions of Audit Committee

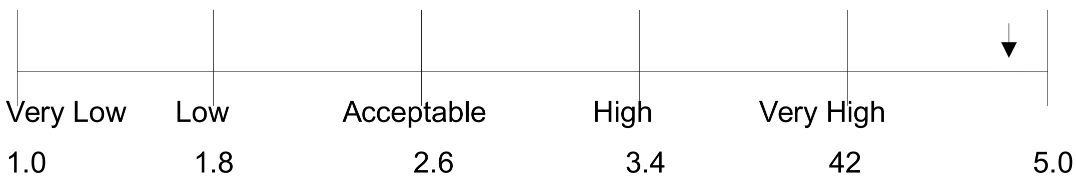
The function of the audit committee on banksthat are listed on the Indonesia Stock Exchange will be revealed through the respondents' answers to the statements in the questionnaire. The average scores of respondents are shown in the picture (results of data processing) as follows:

Figure 3 Scale of the average interpretation Score on function of Audit Committee

2.6 3.4 4.2 5.0

The quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange will be revealed through respondents' answers to the statements in the questionnaire. Furthermore, the grand mean of the calculation resultis interpreted into the interpretation scale table of the respondents' average score that is presented in the following picture:

Figure 4 The Scale of average interpretation Score on Financial Reporting Quality



Effects of The Function of The Board of Commissioners,
Audit Committee and Internal Auditor on Financial Reporting quality

In this section, we will test the effect of commissioners function (X1), audit committee function (X2) and internal auditor function (X3) to the quality of financial reporting (Y) in the banks that are listed on the Indonesia Stock Exchange. Path analysis is applied. Because the respondent's answers data is still in the form of ordinal scale, so in order to make the data possible to be processed using path analysis, Firstly, ordinal data is converted into an interval scale by Successive Interval method. A Pair of interval data from conversion result, then, is used to test the effect of commissioners function, audit committee function and internal auditor function to the quality of financial reporting in banks that are listed on the Indonesia Stock Exchange.

Relationship among the Independent Variables

Before conducting path analysis, firstly, we analyze the relationship among the independent variables (the functions of board of commissioners, audit committee and internal auditor). Based on the processing result, we discovered a correlation coefficient among the three independent variables as shown in the following table.

Table 6 Matric of Correlation among the independent Variables

	X_1	X_2	X_3
X_1	1.0000		
X_2	0.4171	1.0000	

X_3	0.4694	0.3986	1.0000

Source: Path Output Attachment

Based on the value of correlation coefficient in the picture above ,we can can see that:

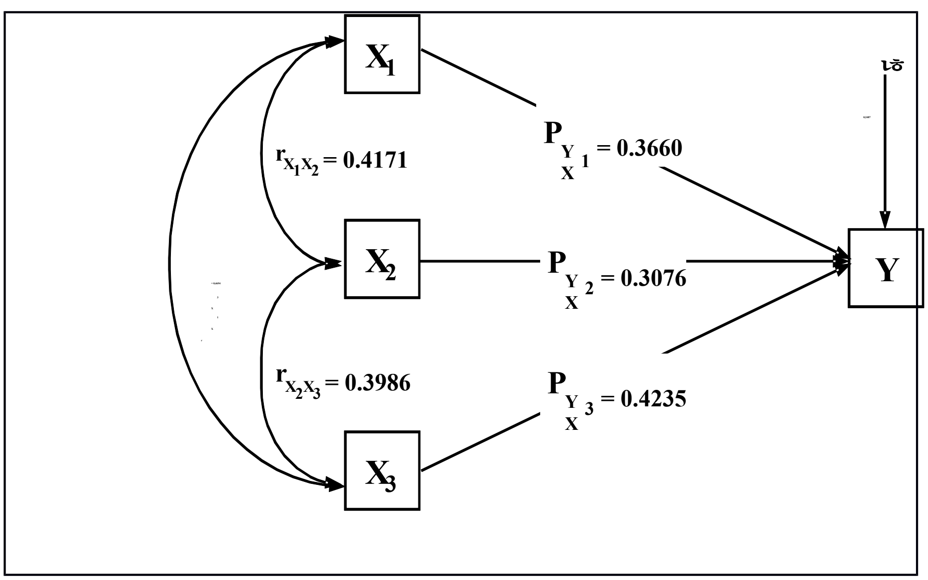
• There is a positive correlation between the functions of board of commissioners and audit committee with a correlation coefficient of 0.4171, The relationship between the functions of both variables is in the moderate category.

• There is a positive relationship between the functions of board of commissioners and internal auditor with a relationship coefficient of 0.4694, This relationship is in the moderate category.

• There is a positive relationshipbetween the functions of audit committee and internal auditor with a relationship coefficient of 0.3986. The relationship is in the low category.

After we analyzed the relationship among these independent variables, we conducted a hypotheses test through path analysis. The processing resulted in a path coefficient of each variables' function to the quality of financial reporting as shown in the following figure.

Figure 5 Diagram of the path of Sub Structure



Through coefficient values in Figure 5, we can calculate the size of the effect of each independent variable (functions of the board of commissioners,audit committee and internal auditor) to the quality of financial reporting.

Table 7 The Quantitative Value of the effects of the Functionn of The Board of Commicionares (X_1), Audit Committee (X_2), and Internal Auditor (X_3) on the Financial Reporting Quality (Y)

Free Variable	Path Coefficient	Direct Effect	Indirect Effect	Total
X_1	0.3660	13.40%	11.97%	**25.37%**
X_2	0.3076	9.46%	9.89%	**19.35%**
X_3	0.4235	17.94%	12,47%	**30.41%**
Combined Effect =				**75.13%**

Among the three independent variables, Internal Auditor had the biggest effect on the financial reporting quality. In the other side, audit committee function had the least effect on the financial reporting quality to the banks that are listed on The Indonesia Stock Exchange.

The Partial Effect of The Board of Commissioner Function on Financial Reporting Quality

Hypothesis :

H0: $\rho YX_1 = 0$ Partially, The Board of Commissisoner function does not give effects on financial reporting quality of the banks that are listed on the Indonesia Stock Exchange

H1: $\rho YX_1 \neq 0$ Partially, The Board of Commissieoner function give effect on financial reporting quality of the banks that are listed on Indonesia Stock Exchange

Table 8 Summary of the Significance Test Results on the effects of Board of Commissioner function to the financial reporting quality

Path Coefficient	T_{count}	$t_{table(db=19)}$	Ho	H_1
0.3660	2.7087	2.093	Rejected	Accepted
Direct Effect = 13.40%		Indirect Effect = 11.97%		Combined Effect= 25.37%

From the test results as described in the table above, it can be seen that the value of $\mathbf{T_{count}}$ (2.7087) is bigger than $\mathbf{t_{table}}$(2093) so with 95% of confidence level there is a strong reason to reject Ho and accept H1. The results of this test indicates that the function of the board of commissioners partially gives a significant effect to the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange.

The Board of commissioners function directly gives 13.40% contribution or effect to the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange, and indirectly give 11.9 % contribution due to their correlation with two other independent variables . So in total the function of the board of commissioners gives 25.37 % contribution/effects of 25.37% in improving the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange.

The Partial effect of Audit Committee Function on Financila Reporting Quality

Hypotesis :

H_0 : $\rho YX_2 = 0$ Partially, Audit Committee Function does not give effects to financial reporting quality in the banks that are listed on the Indonesia Stock Exchange.

H_1 : $\rho YX_2 \neq 0$ Partially, Audit Committee function gives effets to financial reporting quality in the banks that are listed on the Indonesia Stock Exchange.

Table 9 Summary of the test result of the significance of audit committee function on the Quality of financial reporting

Path Coefficient	**T_{count}**	**$t_{table(db=19)}$**	**Ho**	**H_1**
0.3076	2.3646	2.093	Rejected	Accepted
Direct Effect = 9.46%		Indirect Effect = 9.89%		Combined Effect = 19.35%

From the test results as described in the table above, we can see that the value of t_{count} (2.3646) is larger than t table t_{table} (2.093) .with a 95% confidence level, there is strong reason to reject Ho and accept H1. The results of this test indicate that partially, the audit committee function affects the quality of financial reporting in the banks that are listed on the Indonesia stock exchange.

Directly, audit committee function gives 9.46% contribution/effect to the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange, and indirectly 9.89 % contribution is given due to its association with the other two independent variables. Totally, audit committee function gives 19.35 % contribution /effects in improving the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange.

The Partial Effect of Internal Auditor Function on Financial Reporting Quality

Hypotesis :

$H_0 : \rho YX_3 = 0$ Partially, Internal Auditor does not give effects to Financial Reporting Quality in the banks that are listed on the Indonesia Stock Exchange.

$H_1 : \rho YX_3 \neq 0$ Partially, Internal Auditor Function gives effects to Financial Reporting quality in the banks that are listed on the Indonesia Stock Exchange.

Table 10 Summary of the test result of the significance of internal auditor function on the Quality of financial reporting

Path Coefficient	**T_{count}**	**$t_{table\ (db=19)}$**	**Ho**	**H_1**
0.4235	3.1627	2.093	Rejected	Accepted
Direct Effect = 17.94%		Indirect Effect = 12.47%		Total effect = 30.41%

Through the test results as described in the table above, we can see the value of t_{count}(3.1627) is larger than t table t_{table} (2.093). With a 95% confidence level, there is a strong reason to reject Ho and accept H1. The results of this test indicate that partially, the internal auditor function gives a significant effect to the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange.

Directly, internal auditor function gives a 17.49 % contribution / influence to the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange, and indirectly gives 12.47 % contribution due to its relationship with two other independent variables. Totally, internal auditor function gives a 30.41 % contribution / influence of 30.41% in improving the quality of financial reporting in the banks that are listed in Indonesia Stock Exchange.

The Combined Effect of The Board of Commissioners , Audit Committee and Internal Auditor Functionson the Quality of Financial Reporting

H_0 : All $\rho_{YX_i} = 0$, $i = 1,2,3$ — Combination of The Board of Committee. Audit Committee and Internal Auditor Functions do not affect the financial reporting quality in the banks that are listed on the Indonesia Stock Exchange.

H_1 : There $\rho_{YX_i} \neq 0$, $i = 1,2,3$ — Combination of The Board of Committee,Audit Committee and Internal Auditor Functions give effects to the financial Reporting Quality in the banks that are listed on the Indonesia Stock Exchange.

Table 11 The Recapitulation of the Significancetest of the three variables on the Quality of Financial Reporting

R^2	F_{count}	$F_{table\ (db:3;19)}$	Ho	H_1
0.7513	19.132	3.127	Rejected	Accepted

From the table above, we can see that the value of F F_{count}(19.132) is larger than F table F_{table} (3.127).With a 95% confidence level, there is a strong reason for rejecting Ho_1 and receiving Ha_1. It means that the functions of the board of commissioners, audit committee and internal auditor all together give a significant effect to the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange.

Through the great sum of the effects of the three independent variables,partially it can obtain the size of efect from the three independent variables all together.Therefore,the total effects of the functions of board of commissioners, audit committee and internal auditor function all together to the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange = 25.37% + 19.35% + 30.41% = 75.13 %. It means that 75.13% changesoccurs in the quality of financial reporting in the banks that are listed on the Indonesia Stock Exchange is caused by the function of the board of commissioners, the role of audit committee functions and the internal auditor function.While the remaining 24.87% is caused by other factors beyond the three independent variables.

DISCUSSION

Effect of the Board of commissioners on the Financial Reporting Quality

The result of the test conducted by Board of commissioners to the quality of financial reporting showed significant positive results at α = 0.013, so that the indicators in the board ,such as the proportion of the board of commissioners, board size, transparency as well as the task role of commissioner,are very helpful in improving and maintaining the quality of banking financial reporting.

.H.2 Effect of Audit Committee on the Quality of Financial Reporting

Testing hypotheses about the functions of the Audit Committee on the Quality of Financial Reporting influential banking companies listed on the Stock Exchange shows the value of α = 0.028 it is revealed that the role of the audit committee will maximally affect the quality of financial reporting.The result is linier to Marihot Nasution's opinion in National Accounting Seminar. He stated that if audit committee carries out its function effectively, it will reduce earnings management. Baysinger and Butler (1985) stated that the independence and composition of Audit Committee members are important factors in the success of Audit Committee in carrying out its functions.

The Hypotesis Test of financial expertise in the Audit Committee structure,it will determine the quality of financial reporting according to BRC recommendation which has proved that Audit Committee who hold a Certified Public Accountant (CPA), once a member of Audit Committee, or has a good knowledge about auditing, gives positive effectto the situation. Kalbers and Forgarty 's study (1993) discovered two main variables that determine the success of Audit Committee. They are committee's authority and the expertise of committee members and willingness to execute their responsibilities.

The Effect of internal auditor on the Quality of FinancialReporting

The result of Internal Auditor's test on the quality of financial reporting showed significant positive result at α = 0.0051. Therefore, the indicators of internal auditors, such as professionalism, independence, competence, experience,are very helpful in improving and maintaining the quality of banking financial reporting.

**The Simultaneous Effect of the Board of Commissioners,
Audit Committee, Internal Auditor, to the Quality of Financial Reporting**

Based on the result of the data analysis, in the general implementation of corporate governance mechanisms in the banks listed on the Indonesia Stock Exchange has been running well. Based on this result, it can be explained that the mechanism of corporate governance, which is supported by The Board of Commissioners, Audit Committee and Internal Auditor, has asignificantly positive effect onthe quality of financial reporting. This is also linier with the value α = 0.000. This is consistent with the research conducted by Abdel Wahid omri (2000) which stated that the mechanism of corporate gorvenance affects the quality of financial information reporting.

CONCLUSION

Based on the research and analysis conducted ,we can conclude several things as follows:

1. Partially, the effect of Corporate Governance Board mechanism which consists of Commissioners (X1), Audit Committee (X2), Internal Auditor (X3), is to produce a sequence effects; 25.37%, 19.35%, 30.41% on the Quality of Financial Reporting. The effects of X1, X2, X3 variables to Y has a positive direction. This means that if Board of Commissioners, Audit Committee and Internal Auditors are applied properly, the quality of financial reporting is expected to be much better according to the rules of Bank of Indonesia (BI).

2. The combined effect of the Board of Commissioners (X1), Audit Committee (X2), Internal Auditor (X3) is 0.751 or 75.13% and has a positive direction while the remaining 24.87% is affected by other factors that are not examined, such as External Quality Auditor, and organizational culture.

SUGGESTIONS

Based on the conclusions, the suggestions put forward are as follows:

1. Banking leaders are advised to always maintain and obey the rules of Bank of Indonesia to corporate governance mechanisms that consist of:commissioners, audit committees, internal auditors.

2. The subject(s) of this study are thebanksthat are listed on the Indonesia Stock Exchange of which there are limited numbers. It is an opportunity for future researchers to expand the study to other banks and financial institutions such as insurance or leasing companies that are also in providing financial services.

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