# SBE-ICBE 2017

## SBE International Conference on Business and Economy

*Theme:*

**"Creating, Managing, and Distributing Wealth: Advocating Best Practices"**

February 17-18, 2017 ♦ University of San Carlos
Cebu City 6000, Cebu, Philippines

January 12, 2017

**Dr. Sansaloni Butar Butar**
Economics and Business Faculty
Jl. Pawiyatan Luhur IV/1 Bendan Duwur,
Semarang Indonesia

Dear Dr. Butar Butar,

We are pleased to inform you that the abstract of your proposed paper entitled "**CONSEQUENCES OF FINANCIAL RESTATEMENTS FOR DIRECTORS IN INDONESIA**" has been ACCEPTED for presentation at the *3rd SBE International Conference on Business and Economy 2017* (3rd SBE-ICBE 2017) which will be held on **February 17-18, 2017** at the **University of San Carlos, Cebu City, Cebu, Philippines**.

Please note that the final manuscript must be submitted on or before **January 20, 2017** for it to be published in the Conference proceedings. Otherwise, only your abstract will be published. Full papers **must not exceed 20 pages in length**, and **must follow the APA format** *(http://www.apastyle.org/learn/tutorials/basics-tutorial.aspx)*.

The following information will guide you in your participation during the conference:

- **FILENAME**. To facilitate the processing of ***full papers***, may we request that you use the following format in naming your file: **LastnameFirstname-FullPaper.docx** *(no spaces in between please).*
  - *Example:* GozonAllan-FullPaper.docx
  - Papers that do not follow the prescribed format will be returned to the author(s).
  - Attached is the file format guide for your reference. *Please delete the explanatory words enclosed in parentheses when you fill up the form.*

SBE-ICBE 2017

SBE International Conference on Business and Economy

- **REGISTER ONLINE**. For ease of registration, kindly follow this link and fill up the form completely: **https://goo.gl/forms/Tn3iBRgo8hQtRlXp1**

- **BIOSKETCH**. Kindly send your bio sketch(es) with no more than 250 words on or before January 20, 2017 to **uscsbeicbe@gmail.com**. *Please see attached example for your reference.*

- **PAYMENT OF REGISTRATION FEE**. A detailed information and procedure on payment of ***registration fee*** is attached and can also be found in the Call for Paper document posted on our Facebook page *(***https://www.facebook.com/SBE-ICBE 2017***)*. A copy of the transaction or payment slip should be emailed to uscsbeicbe@gmail.com for record purposes.

- **ORAL PRESENTATION FORMAT**. For your oral presentation, kindly use the attached format *(LastnameFirstname SBE-ICBE 2017 Paper Presentation.pptx)* for record purposes. Please send it to **uscsbeicbe@gmail.com** on or before January 20, 2017 for finalization and technical assessment purposes. Where the file is too large to be sent through email, kindly save it on the cloud/Google Drive and send us the shareable link. Kindly bring a backup USB with your presentation files on it just in case. Laptops will not be allowed for use for efficiency and due to technical issues experienced in the past that delayed the presentation proceedings. Unless necessary due to hyperlinks and other requirements, you may inform us ahead of time so we can arrange it during your presentation.

- **ATTIRE**. For Day 1, everybody is encouraged to wear their Filipiniana *(for women)* and Barong Tagalog *(for men)*. For *international attendees*, your ***national costume*** should be worn on the first day. For Day 2, everybody should wear a **corporate/business attire**.

If you have any questions, please do not hesitate to email us at **uscsbeicbe@gmail.com**. For updates about the conference, please visit our Facebook page: *(***https://www.facebook.com/SBE-ICBE 2017***)*.

On behalf of the organizers of the 3rd SBE-ICBE 2017, we would like to thank you for your interest in our conference. More power!

Sincerely yours,

**ALLAN O. GOZON**
Conference Co-Chair
SBE-ICBE 2017

# SBE-ICBE 2017

## SBE International Conference on Business and Economy

*Theme:*

**"Creating, Managing, and Distributing Wealth: Advocating Best Practices"**

February 17-18, 2017 ♦ University of San Carlos
Cebu City 6000, Cebu, Philippines

February 11, 2017

# *Reminders:*

Please note that the final manuscript must have been submitted last **January 20, 2017** for it to be published in the Conference proceedings. Otherwise, only your abstract will be published. Full papers **must not exceed 20 pages in length**, and **must follow the APA format** *(http://www.apastyle.org/learn/tutorials/basics-tutorial.aspx)*.

The following information will guide you in your participation during the conference:

- **FILENAME**. To facilitate the processing of ***full papers***, may we request that you use the following format in naming your file: **LastnameFirstname-FullPaper.docx** *(no spaces in between please).*
    - *Example:* GozonAllan-FullPaper.docx
    - Papers that do not follow the prescribed format will be returned to the author(s).
    - Attached is the file format guide for your reference. *Please delete the explanatory words enclosed in parentheses when you fill up the form.*

- **REGISTER ONLINE.** For presenters and non-presenters who have not yet registered, kindly click on ANY one of the following links and fill up the form completely. *(Note: Register only ONCE using any of the links. Six (6) registration links were created to accommodate the projected number of attendees which cannot be done in one form alone due to the limitations of the software used.)*
    - *Link 1*: https://goo.gl/forms/EdetfcXbcrd6tass1
    - *Link 2*: https://goo.gl/forms/I7C6y31p9GXwKfar2
    - *Link 3*: https://goo.gl/forms/myFbRqS1689vsAGG3
    - *Link 4*: https://goo.gl/forms/7v1WVvFMm8Axnn9x1
    - *Link 5*: https://goo.gl/forms/JTWPP3YiUG3JHxyS2
    - *Link 6*: https://goo.gl/forms/mPLvNO1fDHPNbIw12

SBE-ICBE 2017

SBE International Conference on Business and Economy

- **PAYMENT OF REGISTRATION FEE**. A detailed information and procedure on payment of ***registration fee*** is attached and can also be found in the Call for Paper document posted on our Facebook page *(***https://www.facebook.com/SBE-ICBE 2017***)*. A copy of the transaction or payment slip should be emailed to uscsbeicbe@gmail.com for record purposes. ***Payment should be made per individual who will attend.***

- **ATTIRE**. For Day 1, everybody is encouraged to wear their Filipiniana *(for women)* and Barong Tagalog *(for men)*. For *international attendees*, your ***national costume*** should be worn on the first day. For Day 2, everybody should wear a **corporate/business attire**.

If you have any questions, please do not hesitate to email us at **uscsbeicbe@gmail.com**. For updates about the conference, please ***like*** our Facebook page: *(***https://www.facebook.com/SBE-ICBE 2017***)*.

On behalf of the organizers of the 3rd SBE-ICBE 2017, we would like to thank you for your interest in our conference. More power!

Sincerely yours,

**ALLAN O. GOZON**
Conference Co-Chair
SBE-ICBE 2017

FAKULTAS EKONOMI DAN BISNIS
Jl. Pawiyatan Luhur IV/1 Bendan Duwur Semarang 50234
Telp. (024) 8441555,8505003 (hunting) Fax.(024) 8415429 - 8445265
e-mail:unika@unika.ac.id http://www.unika.ac.id

Unika SOEGIJAPRANATA

# LETTER OF DUTY AFFIRMATION

No. 0582/K.6.4/ST/FEB/II/2017

To Whom It May Concern,

The Undersigned below, Dean of Facultyof Economics and Business, Soegijapranata Catholic University, Semarang, Indonesia hereby assigns:

| | | |
|---|---|---|
| Name | : | Dr. Sansaloni Butar Butar, M.Si.,Akt. NIDN : 0605076901 |
| Occupation | : | Lecturer, Full Time Faculty Member of Faculty of Economics and Business, Soegijapranata Catholic University (SCU). (Department of Accountancy) |
| Address | : | Jl. Pawiyatan Luhur IV / 1 Bendan Duwur, Semarang. 50234, Central Java, Indonesia. |
| Activity | : | Research Presenter on the topic **"Consequences of Financial Restatement for Directors in Indonesia"** with the themes "***Creating Managing, and Distributing Wealth : Advocating Best Practices***" |
| Time and Place | : | February 17, 2017, at University of San Carlos, Cebu, Philippines. |

This letter is issued for whatever it might deem useful to him.

Semarang, February 17, 2017
Dean

FAKULTAS EKONOMI DAN BISNIS

Sentot Suciarto A., Ph.D

UNIVERSITY of SAN CARLOS

SCIENTIA • VIRTUS • DEVOTIO

UNIVERSITY of SAN CARLOS

SBE SCHOOL OF BUSINESS & ECONOMICS

CENTER for ENTREPRENEURSHIP and LIFELONG LEARNING

# SBE-ICBE 2017

**SBE International Conference on Business and Economy**

17-18 February 2017 • University of San Carlos • Cebu City • Philippines

*Awards this*

## CERTIFICATE OF RECOGNITION

*to*

## *SANSALONI BUTAR BUTAR, PhD*

as Research Presenter on the topic
*"Consequences of Financial Restatement for Directors in Indonesia"*
during the **SBE International Conference on Business and Economy (SBE-ICBE) 2017**
with the theme: ***"Creating, Managing, and Distributing Wealth: Advocating Best Practices"***
held at the University of San Carlos, Michael Richartz Building Tourism Center,
School of Business and Economics, Talamban Campus.

Given this 17th day of February 2017, Cebu City, Philippines.

**MELANIE B. DE OCAMPO, PhD BA**
Conference Chair, SBE-ICBE 2017

**CHALLONER A. MATERO, CPA, DPA**
Dean, School of Business and Economics

**FR. DIONISIO M. MIRANDA, SVD, SThD**
President, University of San Carlos

80 YEARS

CREATING, MANAGING AND DISTRIBUTING WEALTH: ADVOCATING BEST PRACTICES

University of San Carlos – School of Business and Economics
Center for Entrepreneurship and Lifelong Learning
**International Conference on Business and Economy 2017**

*Theme:* **Creating, Managing, and Distributing Wealth: Advocating Best Practices"**
February 17-18, 2017, University of San Carlos
Cebu City 6000, Cebu, Philippines

# Causequences of Financial Restatements for Directors in Indonesia



| | Author | Co-Author | Co-Author 2 | Co-Author 3 | Co-Author 4 |
|---|---|---|---|---|---|
| University | Sansaloni Butar Butar | - | - | - | - |
| Department Name | Accounting Department | | | | |
| Mailing Address | Jl Pawiyatan Luhur IV/1 Bendan Duwur Semarang | | | | |
| Country Name | Indonesia | | | | |
| Telephone Number | +622476918619 | | | | |
| Facsimile Number | +6248445265 | | | | |
| Mobile Number | +6287832033986 | | | | |
| Email | sansaloni@unika.ac.id | | | | |



## ABSTRACT

High quality accounting information are indispensable for investors, managers and other interested parties to make reasonable decisions. Therefore, accounting number reflected in financial statements are to be transparent, complete, and fair. When a company restates its financial statements, the figures presented in the financial statements no longer reflect the firm economic reality and may lead to serious economic consequences. Financial restatements issues have not received much attention in Indonesia. So far, problems related to financial reporting are more to do with manipulation of financial statements. Therefore, the objective of this study is to examine the consequences of financial restatements in Indonesia. The study consists of two parts.

The first part is to assess the impact of corporate governance on restatements. Previous studies assumed that financial restatements can be reduced by establishing good corporate governance. However, empirical studies relating financial restatements and the characteristics of boards or the audit committee found inconsistent results. Thus the effect of corporate governance on financial restatement is still empirical questions in Indonesia. In this study, restating firms are identified by observing annual report of samples firms from 2010 to 2014. There are 36 companies that restates their financial statements during the sample period. As control samples, 34 non-restating firms are also included to test the hypothesis. Using logistic regression, I find that audit committee' s financial expertise is negatively related to financial restatements but no significant results for board of commissioners.

The second part of this study to examine the impact of financial restatement on management turnover. As largely discussed in literature, managers have an important role in financial reporting process and are fully responsible for the quality of financial statements. But the occurrence of restatements indicate that the prior financial statements are not based on generally accepted accounting principles and may threaten the legitimacy of organizations.

Therefore, this study predicts that corporate managers who do restatement are more likely to lose his job. In this study, management turnover refers to the likelihood of chief director (president director) and director of firms lose their jobs within 24 months after financial restatement. More specifically, this study compares manager turnover between restating firms and non-restating firms. Using logistic regression, the results show that earnings restatements cause managers to lose their jobs. As much as 79% of restating companies managers losing their jobs compared to only 38% of managers losing their jobs in non-restating firms.

Keywords: earnings restatements, management turnover, corporate governance, financial reporting quality.

## 1. Introduction

Credible accounting information are very useful to make informed decision and evaluate firms future prospects. Unfortunately accrual accounting allows managers to use discretion and opens up a chance to intervene financial reporting process. Agency theory suggests lack of control may lead to conflict of interests between stockholders and managers. Consequently, adequate monitoring mechanisms should be established to prevent managers from using firms resources opportunistically and to help induce goal congruent among stakeholders. Good corporate governance may help aligning the interest of stockholders and and management. However, financial and accounting scandals of major companies in the United States have raised concerns about the adequacy of corporate governance in safeguarding firms asset. A series of financial and accounting scandals reported by media in 2000-2002 have eroded credibility of financial reporting (Jain and Rezaee, 2006; Cohen et.al., 2008). Although fraudulent financial statements cases have been subsided in the following years, another form of accounting misapplications are reflected in financial restatements. Simply put, financial restatements are corrections of errors resulting from non-compliance of GAAP ((Scholz, 2014; Palmrose et.al.2004). Various factors have been proposed to explain the increasing incidence of financial restatements including accounting standards, changes in the limits of materiality, auditors, earnings management, increasing complexity of firms transactions, and meet analyst forecasts (Plumlee and Yohn 2010).

Empirical evidence on the association between corporate governance and financial restatements have been mixed. Using financial restatements of publicly held companies in China, Zhizhong et.al (2011) document evidence that strong corporate governance lower the incidence of financial restatements. Moreover, they showed that board independence and audit committee are negatively associated with financial restatements. Abdullah et.al (2010) had investigated restating firms listed on Bursa Malaysia and provided evidence that the percentage of shares owned by outside blockaders is negatively associated with restatements. Although the audit committee is significantly associated with restatements, the hypothesized direction is not consistent with observed direction. However, board independence and auditor quality are not significantly related to restatements. Nasri and Mohammadi (2015) examined firms that restated earnings from Tehran Stock Exchange and found a significant correlation between financial restatements and board independence. Audit committee is also found to be negatively associated with restatements. Meanwhile, empirical studies that examine the effect of corporate governance on financial restatements in the United States find inconsistent results. Larcker et.al (2007) examined the association between corporate governance and the accounting (economic) outcomes. The evidence suggests a weak correlation between corporate governance and financial restatements. On the other hand, Baber et.al (2010) examined financial restatement in 1997-2002 and provide evidence that financial restatements is negatively associated with corporate governance. Baber et.al (2012) attempted to explain the inconsistent result by separating corporate governance into internal governance and external governance and examine the impact of both types of governance in the context of Sarbanes-Oxley Act. In their study, internal governance refers to the monitoring functions of board of directors. External governance refers to the ability of shareholders to influence the decisions made by both management and board of directors. Results showed that corporate governance characteristics and the probability of restatement before the Sarbanes-Oxley (SOX) Act are not significantly related. On the other hand, the relationship between financial restatements and corporate governance characteristics after SOX are found to be significant.

In addition to empirical studies on the cause of financial restatements, empirical analysis also attempts to assess the effect of financial restatements on firm value and on management turnover. Palmrose et.al (2004) examined market reaction to financial restatements in 1995 to 1999. They reported average abnormal return of about -9 percent over a two-day announcement window. They also found more negative returns attributed to auditors and management turnover. Palmrose and Scholz (2004) separated the cause of financial restatements into regular, recurring earnings from primary operations (core) or other components of earnings (noncore) and examine its impact. Results showed that restating firms experienced decreasing stock price over six months preceding and following restatement announcements and some of them were bankrupt.

Although financial restatements are also very common in Indonesia, unlike their counterpart worldwide, the business community and accounting profession have not shown great concern over restatements issues. Therefore, empirical study related to the restatement are also quite rare. One reason is the availability of financial retirements data. Cases of financial statements irregularities are more related to fraudulent financial reporting. One case of fraudulent financial reporting that had received wide publication by media is the financial statement manipulation of Bank Lippo and Kimia Farma. Put it in Indonesia context, empirical study to identify the factors causing financial restatements is still interesting. Not to mention the different characteristics of corporate governance implemented by Indonesian publicly held company. Note that two tier system of corporations in Indonesia consists of a board of directors and a board of commissioners. Board of commissioners are responsible for monitoring board of directors while board of directors are responsible for managing and running the company. Therefore, the term " board of commissioners" is used to describe corporate governance practice in Indonesia. Unlike developed countries, monitoring functions of board of directors and audit committee in Indonesia are questionable. One factor that is frequently cited is the lack of monitoring and business knowledge. Some firms hired outside directors only to comply with regulations but had failed to select competent and skilful side directors.

The objectives of this study are twofold. First, this study seeks to assess the effect of corporate governance on financial restatements among Indonesian publicly listed companies. Specifically, this study investigate whether board of commissioners independence, audit committee expertise, and ownership structure are associated with the incidence of financial restatements. Second, this study examines the consequences of financial restatements for directors following financial restatement. Again, in this study the term ' directors' refer to firm executives not board of director as used in USA. To eliminate terminology confusion, this study keeps the term ' board of directors' as in United States to build argument underpinning the hypotheses but use the term ' board of commissioners' to state the hypotheses.

In this study, restating firms are identified by observing annual report from 2010 to 2014. There are 36 companies that restated their financial statements during sample period. As control samples, 34 non-restating firms are also included as sample. Using logistic regression, I find that audit committee’ s financial expertise is negatively related to financial restatements but no significant results found for board of commissioners and intstitutional ownership. The effect of restatements on management turnover are assessed by comparing management turnover between restating firms and non-restating firms. Here firm management include president director, vice president director, and directors. Using logistic regression, the results show that earnings restatements cause managers to lose their jobs. As much as 79% of managers of restating companies lost their jobs compared to only 38% of managers loosing their jobs in non-restating firms.

## 2. Literature review and hypothesis development

Financial restatements occur when published financial statements are not based on GAAP. There are various factors that drive company to issue restatements. Abbot et.al (2004) described factors that contribute to financial restatements. First, inherent factors like aggressive accounting practices, incorrect application of GAAP, and personnel problems. Second, firm internal control is not effective in preventing or detecting misstatements. Third, external auditors fail to detect misstatements. Financial restatement can be initiated by company, auditors, or driven by regulation.

Flanagan et.al (2008) conducted an exploratory study using 919 restatements cases issued by the General Accounting Office (GAO) between January 1, 1997 and June 30, 2002. They showed that financial restatements are not always associated with fraud, some are driven by company actions such as mergers, acquisitions, discontinued operations, stock splits and currency issues. But the most dominant factor are errors in revenue and cost (expenses) recognition, and asset restructuring. Slightly different, Huron Consulting Group (2003) as cited by Abdullah et.al (2010) reported that the main factors driving restatements are revenue recognition, equity accounting, reserves, accruals, and contingencies.

Prior studies documented evidence that financial restatement has a negative effect on firm value. Richardson et.al (2002) reported a decrease in stock value after restatements. Hribar and Jenkins (2004) showed that restating firms experienced higher cost of capital. Palmrose et al. (2004) reported a negative abnormal return two days around restatements. In addition, many restating firms went bankrupt or involved in litigation. Byrnes et al. (2002) reported that restatements causing investors to have negative perception on firms’ auditor. Palmrose and Sholz (2004) found that market participants react negatively to stock price of restating firms. Financial restatements also have effect on manager reputation. Desai et.al (2006) found that managers who restated earnings have a higher likelihood of losing jobs compared to companies that did restatements.

The role of corporate governance in reducing restatements has attracted many researchers from various countries. In addition to Larcker et.al (2007) and Baber et.al (2012) that have been previously described, several studies like Abbott et.al (2004) and Agrawal and Chadha (2005) also use data from US capital markets to assess the role of corporate governance in preventing financial restatements. Prior Studes using developing capital markets include La Porta et.al (1999) and Zhizhong et.al (2011).

### Restatement and Board independence

Concerns over the abuse of authority by firm managements intensify the crucial role of board of directors to align the interest of stockholders and managers. As a representative of stockholders, it is the responsibility of board of directors to make sure that firm resources have been used efficiently in the best interest of stockholders. Board of directors assisted by audit committee have to make sure that firm adopt sound accounting policy as a basis for financial report and all economic events are accounted for. This is the central function of board of directors (Klein, 2002; Carcello and Neal, 2000; Beasley, 1996; Dechow et al. 1996).

Failure to reduce management intervention on financial reporting process may bring harm to investors. Various factors, ranging from the low competence of board members (Xie et al. 2003) to the issue of independence, give rise to opportunistic behavior of firm managers (Klein, 2002). But effective monitoring functions are hard to expect from board when they can not express their thoughts and constructive criticism openly and freely. Therefore it is very crucial to have people from outside company to join board of directors. In situation where management exert pressure on board, independent directors are expected to have more courage to stand up against the pressure relative to inside members, particularly with respect to the financial reporting process.

Byrd and Hickman (1992) suggested that the expertise and experience of outside directors may prevent and mitigate improper use of firm resource by management. Meanwhile, Beasely (1996) and Dechow et.al. (1996) reported a negative association between the proportion of independent directors with financial statement fraud. Klein (2002) found the proportion of independent directors are negatively related to abnormal accruals. Xie et al. (2003) provide evidence of a negative relationship between earnings management and the independent representatives who joined board of directors. In addition, they also found that board monitoring function increased as the number of directors who have expertise in finance are also increased. These previous empirical findings emphasize the strategic role of independent directors in reducing opportunistic behavior of managers.

Outside directors are expected to enhance board monitoring functions because they bring extensive experience and expertise into company (Kaznik, 1987). Fama and Jensen (1983) suggest that outside directors have strong incentive to provide more effective supervision than inside directors because they have to maintain good reputation as an independent party. They can mitigate agency conflict between stockholders and company management. Prior studies suggest that investors perceive financial restatements as a sign of mismanagement and caused them to react negatively against firm value. As described before, this study use the term ‘ board of directors’ in describing conceptual arguments but ‘ board of commissioners’ is used to state hypothesis. Thus, the association between board independence and financial restatement is stated in following hypothesis:

**H1: Board of commissioners independence is negatively associated with financial restatements**.

### Financial restatements and Audit committee expertise

Various cases of fraudulent financial statements have encouraged investors and regulators to question the basic principles of corporate governance adopted by firms, especially the role of audit committee to maintain financial reporting quality. New regulations are imposed to strengthen audit committee function. One of them is to make audit committee liable for misleading financial statements. On 29 November 2004 the head of Indonesian Capital Market supervisory board issued regulation stated that directors and commissioners may be held accountable individually for taking part directly or indirectly in presenting misleading financial statements. As a sequence, misleading financial statements may trigger investors and other parties to to bring a lawsuit against audit committee. Prior studies suggest lawsuits against audit committee are always there. Brochet and Srinivasan (2013) provided evidence that side directors who are also audit committee members have a high chance of being sued and losing jobs. Linck et.al (2008) reported several legal cases against directors that required them to pay large amount of money.

Publicly held companies in Indonesia are also required to establish an audit committee with entire members come from outside company and at least one member of the audit committee have expertise in accounting and or finance. As a result of incorrect application of accounting policy and methods, financial restatement is a sign that audit committees are not function effectively. Therefore, audit committee members who have expertise in finance or accounting are expected to have the ability to verify accounting policies and methods used in preparing financial statements. On the other hand, it is hard to expect audit committee members who do not have accounting or finance background have the capability in identifying unacceptable accounting policy. Prior studies have shown that firm having audit committee with financial or accounting expertise reduce abnormal accruals, financial restatements and lawsuits against them (Abbot et.al 2004; Bedard et al., 2004; Agrawal and Chadha 2005). Therefore, it can be expected that audit committee with expertise in finance or accounting is more capable of discovering accounting irregularities and reduce the probability of earnings restatements. The relationship between the audit committee and financial expertise restatements can be stated as follows:

**H2: Firms having an audit committee with larger financial or accounting expertise are associated with a lower incidence of financial restatements**

**Monitoring function of institutional investors**

According to agency theory conflict of interest between stockholders and managers can be reduced by establishing monitoring mechanism by which policies and actions taken by management are always controllable and consistent with company’ s objective. Institutional investors can play a significant role in monitoring managers’ actions and strategy. This has been discussed widely in finance and accounting literature. Previous empirical research found that the ownership structure can reduce agency problem (Shleifer and Vishny, 1986; La Porta et.al 1999). In finance literature, effect of ownership structure on various measures of performance can be explained by efficient monitoring hypothesis. This hypothesis predicts the higher the concentration of ownership, the higher the motivation of large stockholders to monitor company. Investors with large ownership are more willing to play an active role in influencing operation and decisions made by firm management given the potential benefit of active involvement (Grossman and Hart, 1986). The methods used to influence firm’ s decisions ranging from informal conversation to a threat of takeover.

Large ownership is a common phenomenon in many countries and generally held by institutional investors (Shleifer and Vishny, 1986). Hartzell et al. (2014) suggests that institutional ownership improve monitoring process of managers activities and reduce agency costs. Since financial restatements is a reflection of decreasing financial statements quality, then it is expected that monitoring role of institutional investors may reduce the incidence of financial restatements. The role of institutional ownership in reducing financial restatements can be stated as following hypothesis:

**H3: Institutional ownership is positively associated with financial restatement**

**Managements turnover and restatements**

Investors demand credible financial statements. Deviations from GAAP leading to financial restatements is a sign that firms are doing mistakes. As a consequence, managers are to take responsible for all errors and mistakes in previous financial statements (Palmrose and Scholz, 2004). Empirical studies that examine the impact of financial restatements and management turnover found inconsistent results. Agrawal et al. (1999) and Beneish (1999) failed to identify a significant association between management turnover and financial restatements. These findings suggest that market participants do not consider financial restatements as something harmful to the company. However, a series of accounting scandals occurred in the last two decades have raised concerns over the adequate of corporate governance in preventing misleading financial statements. Studies conducted in subsequent years provide evidence that managers of restating firms lost his job following financial restatements (Srinivasan, 2005; Desai et al., 2006; Lee and Liao, 2013). The consequences of restatements is stated in following hypothesis:

**H4 Management turnover is positively associated with financial restatement**

## Research design

This study consists of two parts. The first part is to examine factors that effect financial restatements. The second part it to test the consequences of financial restatements. The following logist ic regression models are performed to test the hypotheses

Model 1: Association between financial restatements and corporate governance:

$$Restate_{it} = \beta_0 + \beta_1 Indp_{it} + \beta_2 Aud\_Com_{it} + \beta_3 Inst\_Own_{it} + \beta_4 Big4_{it} +$$
$$\beta_5 Lev_{it} + \beta_6 Size_{it+} + \varepsilon_{it}$$

Variable definitions: Restate = 1 if the company restated its earnings, 0 otherwise; Aud_com = the number of audit committee member with financial or accounting expertise; Inst_Own = the percentage of shares held by institution; Big4 = 1 if company audited by accounting firms that have affiliated with Big4, 0 otherwise; Lev = debt to asset ratio; Size = logarithm of total assets

Model 2: Association between financial restatements and management turnover:

$$Turnover_{it} = \beta_0 + \beta_1 Restate_{it} + \beta 2 Block_{it} + \beta_3 Return_{it} + \beta_4 Man\_Own_{it} +$$
$$\beta_5 Roa_{it} + \beta_6 Size_{it} + \varepsilon_{it}$$

Variable definitions: Turnover = dummy variable equals 1 if a company replace its management (president directors, vice president directors, and directors) 0 otherwise; Block = the number of stockholders who own firm' s stocks 5% or more; Return = stock return 3 months prior to restatements; Man_Own = the percentage of shares held by institutions; Roa = net income to asset ratio; Size = log of total assets.

## Data and sample selection

The population of this study is all companies listed in Indonesia Stock Exchange in the period of 2010-2014. Financial data are collected from Indonesian Stock Exchange website www.idx.co.id , and Indonesian Capital Market Directory (ICMD) published by the Institute for Economic and Financial Research. Firms that restated earnings are identified from annual report. Financial restatements caused by mergers and acquisitions were excluded from the sample. During sample period there are 36 companies that restated its financial restatements: 5 in 2010, 6 in 2011, 8 in 2012, 4 in 2013, and 13 in 2014. Non-restating firms are selected as a control group by match-pair procedures based on industry groups and size.

There are 34 companies that meet these criteria. Thus, the final sample to test the hypothesis consist of 70 companies.

**Descriptive Statistics**

Table 1 presents descriptive statistics of all variables used in the study

**Table 1. Descriptive statistics**

| | Restating firms | | Non-restating firms | | |
|---|---|---|---|---|---|
| | Mean | Median | Mean | Median | *t-statistics* |
| Turnover | 0,78 | 1,00 | 0,35 | 0,00 | 3,917* |
| Indp | 0,45 | 0,42 | 0,48 | 0,50 | -0,817 |
| Big4 | 0,53 | 1,00 | 0,38 | 0,00 | 0,228 |
| Inst_Own | 0,64 | 0,62 | 0,63 | 0,65 | 0,156 |
| Block | 2,53 | 2,00 | 2,15 | 2,00 | 1,045 |
| Leverage | 0,63 | 0,64 | 0,59 | 0,60 | 0,587 |
| Aud_Com | 2,06 | 2,00 | 2,56 | 2,00 | -2,273** |
| Size | 9,69 | 9,50 | 10,03 | 10,27 | -0,643 |
| Return | 0,02 | -0,01 | 0,10 | 0,00 | -1,043 |
| Roa | 0,02 | 0,02 | 0,02 | 0,03 | -0,083 |

Notes: *$P$ <0,05, **$P$<0,05, *two- tailed test* , $n$=70

The mean management turnover for restating firms and non-restating firms are 0.78 and 0,35 respectively indicating that 78% of restating firm directors have been replaced compared to only 35% for non-restating firms. The different between these two groups was highly significant suggesting that financial restatements are associated with management turnover. The mean audit committee for restating and non-restating firms are 2.06 and 2.56 respectively. They suggest that non-restating firms have more audit committee members with finance or accounting background than restating firms. Meanwhile, board independence and institutional ownership between this two group were not statistically different. The same was true for control variables indicating similar characteristics between restating and non-restating firms. This adds to the validity of results .

**Results and discussion**

Logistic regressions results for H1, H2, and H3 can be seen in Table 2. Hypothesis one (H1) predicts a negative association between board independence and the incidence of financial restatements. The results do not support the hypothesis. The insignificant result may be explained by low quality of outside directors. This is possible because firms hire outside directors just to comply with regulation imposed by Indonesian security exchange commission that require firms to establish board of commissioners comprising at least 30% from outside directors. It has become common practice in Indonesia to hire former state officials or former soldiers and those who have an affiliation with a particular political party to become a member of the board of commissioners. Most of them do not have skills and capability to perform monitoring function.

**Table 2**
**Logistic regression results (restatement =1)**

| Variable | Expected signs | Without control variables | | | With control variables | | |
|---|---|---|---|---|---|---|---|
| | | Coefficient | SE | *p-value* | Coefficient | SE | *p-value* |
| Indp | - | 0.044 | 1.00 | 0.984 | -1.425 | 2.484 | 0.566 |
| Aud_Comm | - | -0.623 | 0.42 | 0.045* | -0.649 | 0.329 | 0.048* |
| Inst-Own | - | 0.485 | 1.00 | 0.681 | 0.606 | 1.214 | 0.618 |
| Big4 | - | - | - | - | 0.557 | 0.666 | 0.403 |
| Lev | ? | - | - | - | 1.533 | 1.214 | 0.207 |
| Size | ? | - | - | - | 0.012 | 0.153 | 0.938 |

Notes: *$P$ <0,05

Hypothesis two (H2) predicts the number of audit committee members who have expertise in accounting and finance reduce financial restatements. Knowledge of accounting or finance enable audit committee to identify accounting policies that deviate from GAAP and make adjustments before financial statements are issued. The hypothesis was supported.

Hypothesis three (H3) predicts that the number of shares owned by institutional stockholders reduce the incidence of financial restatements. The result does not support the hypothesis. In addition, none of control variables are associated with financial restatement.

The next analysis focuses on the consequences of financial restatements for firms' managements (directors). As described before, the correction of previous financial statements gives a negative signal to market participants. Market perceives something bad has happened

**Table 3.**
**Logistic regression result ( management turnover =1)**.

| Variable | Expected signs | Without control variables | | | With control variables | | |
|---|---|---|---|---|---|---|---|
| | | Coefficient | SE | *p-value* | Coefficient | SE | *p-value* |
| Restate | + | 1.859 | 0.538 | 0,001* | 1.819 | 0,582 | 0,002* |
| Return | ? | - | - | - | -0,054 | 0,894 | 0,951 |
| Block | - | - | - | - | 0,124 | 0,217 | 0,567 |
| Man_Own | ? | - | - | - | 13,874 | 1,861 | 0,173 |
| Roa | - | - | - | - | 0,741 | 2,361 | 0,754 |
| Size | ? | - | - | - | -0,156 | 0,141 | 0,270 |

Notes: *$P$ <0,01

to the company and the credibility of management to manage the company's resources are in questions. In this study management turnover refers to any replacement of directors who served as president directors, vice president directors, and directors. If the incidence of restatements induce firms to change directors then it is predicted coefficient for Restate is positive and statistically significant. The results stated in Table 3 are consistent with this prediction. Thus the hypothesis four is supported

## Conclusion

This study examines the role of board of directors, audit committee, and institutional ownership in reducing financial restatements of publicly held companies listed on Jakarta Stock Exchange. Using 36 companies that restate their financial restatements during 2010-2015 and 34 companies that do not restate their financial restatements as a control group, the findings show that the number of audit committee having expertise in accounting and finance are negatively associated with lower the incidence of financial restatements. Meanwhile, the board of commissioner independence has no effect on financial restatements. All control variables do not affect the financial restatements.

In addition to the determinants of restatements, this study also examines management turnover following the release of financial restatements. Definition of management turnover refers to the changes in board of directors after financial restatements. It should be noted that the term directors in Indonesia is different than those adopted in United States. In US board of directors functions are to monitor and oversee manager of the firms. Meanwhile board of directors in Indonesia refer to executives or managers who manage and run the company. The party who monitor board of directors is called board of commissioners. Essentially board of commissioners in Indonesia have nearly same task as board of directors known in the United States. Firms that replace president, vice president, or directors, are classified as management turnover. The findings indicate that the incidence of restatements cause firms to change the composition of firms management.

## References


Abbott, J.L., Parker, S. and Peters, G.F. 2004). Audit committee characteristics and restatements. *Auditing*, Vol. 23, pp. 69-87.

Abdullah, S.N; Yusof, M.Z.N, and Nor, M.N.M. 2010. Financial restatements and corporate governance among Malaysian listed companies. *Managerial Auditing Journal* Vol. 25 No. 6, 2010 pp. 526-552

Agrawal, A., J.F. Jaffe, & J.M. Karpoff. 1999. Management turnover and governance changes following the revelation of fraud. *Journal of Law and Economics, 17,* 309-342.

Agrawal, A. and Chadha, S. 2005. Corporate governance and accounting scandals. *Journal of Law & Economics*, Vol. 48, pp. 371-406.

Baber, W., Kang, S., Liang, L., Zhu, Z., 2010. Shareholder rights, corporate governance and accounting restatement. *Working paper*, Georgetown University.

Baber, W.R, S., Liang, L., and Zhu, Z., 2012. Associations between Internal and External Corporate Governance Characteristics: Implications for Investigating Financial Accounting Restatements. Accounting Horizons, Vol. 26, No. 2: 219-237

Bargeron, L.L; K.M. Lehn; and C.J. Zutter; 2010. Sarbanes-Oxley Act and corporate risk-taking. *Journal of Accounting and Economics 49: 34-52*

Beasley, M. 1996. An empirical analysis of the relation between the board of director composition and financial statement fraud. *The Accounting Review, Vol. 71, pp. 443-65.*

Bedard, J.C., & K.M. Johnstone. 2004. Earnings manipulation risk, corporate governance risk, and auditors' planning and pricing decisions. *The Accounting Review, 79,* (2), 277-304.

Beneish, M.D. 1999. Incentives and penalties related to earnings overstatements that violate GAAP. *The Accounting Review*, Vol. 74, No. 4, pp.425–457

Brochet, F and S. Srinivasan. 2013. Accountability of independent directors: Evidence from firms subject to securities litigation. *Journal of Financial Economics,* Vol. 111, Issues 2: 430-449

Byrd, J.W., and K.A. Hickman. 1992. Do outside directors monitor managers? Evidence from tender offer bids. *Journal of Financial Economics 32, 195–222.*

Byrnes, N., M. McNamee, D. Brady, L. Lavelle, and C. Palmeri. 2002. Accounting in crisis: Reform is urgent. *Business Week* (January 28): 44-49.

Carcello, J., and Neal, T. 2002. Audit committee composition and auditor reporting. *The Accounting review* 75, 453-467.

Dechow, P., R. Sloan, and A. Sweeney. 1996. Causes and consequences of earnings manipulation: an analysis of firms subject to enforcement actions by the SEC. *Contemporary Accounting Research* 13 (1): 1-36.

Desai, H., C. Hogan, and M. Wilkins. 2006. The reputational penalty for aggressive accounting: earnings restatements and management turnover. *The Accounting Review* 81: 83-112.

Eilifsen, A. and Messier, W.F. 2000. The incidence and detection of misstatements: a review and integration of archival research. *Journal of Accounting Literature*. Vol. 19, pp. 1-43.

Engel, E., R.M. Hayes, and X. Wang. 2007. The Sarbanes-Oxley Act and firms'going-private decisions. *Journal of Accounting and Economics 44, 116-145.*

Flanagan, D.J., Muse, L.A. and O'Shaughnessy, K.C. 2008. An overview of accounting restatement activity in the United States. *International Journal of Commerce & Management*, Vol. 18, pp. 363-81.

Fama, E. and Jensen, M.C. 1983. Separation of ownership and control. *Journal of Law & Economics*. Vol. 26, pp. 301-26

General Accounting Office (GAO). 2003. *Financial statement restatements: trends, market impacts, regulatory responses, and remaining challenges*. GAO-03-138. Washington, D.C.: Government Printing Office.

Gleason, C., N. Jenkins, and W. Johnson. 2008. The contagion effects of accounting restatements. *The Accounting Review* 83 (1): 83-110.

Grossman, S. J., and Hart, O. D. 1986. The costs and benefits of ownership: A theory of vertical and lateral integration. *Journal of Political Economy*, 94, 4, 691-719

Hartzell, J.C., Sun, L., Titman, S., 2014. Institutional investors as monitors of corporate diversification decisions: Evidence from real estate investment trusts. *Journal of Corporate Finance* 25, 61-72

Hennes, K. M., A. J. Leone, and B. P. Miller. 2008. The importance of distinguishing errors from irregularities in restatement research: the case of restatements and CEO/CFO turnover. *The Accounting Review* 83 (6): 1487-1519.

Hennes, K. M., A. J. Leone, and B. P. Miller. 2012. Accounting restatements and auditor accountability. Working paper, University of Oklahoma.

Hribar, P., and N. T. Jenkins. 2004. The effect of accounting restatements on earnings revisions and the estimated cost of capital. *Review of Accounting Studies* 9: 337-356.

Hribar, P., N. Jenkins, J. Wang. 2009. Institutional investors and accounting restatements. *Asian Journal of Finance and Accounting* 1(2) 75–105

Jain, P.K., and Z. Rezaee. 2006. The Sarbanes-Oxley Act of 2002 and capital market behavior: early evidence. Contemporary Accounting Research 23 (3): 629-654

Cohen, D.A; A. Dey, and T.Z Lys. 2008. Real and accrual based-earnings management in the pre-and post-Sarbanes-Oxley periods. *The Accounting Review* 83, 757-787

Larcker, D. F., S. A. Richardson, and I. Tuna. 2007. Corporate governance, accounting outcomes, and organizational performance. *The Accounting Review* 82(4): 963-1008.

La Porta, P., Lopez-de-Silanes, F. And Shleifer, A. 1999. Corporate ownership around the world. *Journal of Finance*, 54, 471-517

Kosnik, R.D. 1987. Greenmail: a study of board performance in corporate governance. *Administrative Science Quarterly*, Vol. 32, pp. 163-85.

Palmrose, Z.V. and Scholz, S. (2004), 'The circumstances and legal consequences of non-GAPP reporting: Evidence from restatements', *Contemporary Accounting Research*, Vol. 21, No. 1, pp.139–190.

Palmrose, Z. V., V. Richardson, and S. Scholz. 2004. Determinants of market reactions to restatement announcements. *Journal of Accounting and Economics* 37: 59-89.

Plumlee, M., and T. L. Yohn. 2010. An analysis of the underlying causes attributed to restatements. *Accounting Horizons* 24 (1): 41-64.

Richardson, S., Tuna, I., Wu, M., 2002. Predicting earnings management: The case of earnings restatements. Working paper, University of Pennsylvania.

Scholz, S. 2014. Financial restatement trends in the United States: 2003-2012. Center for audit quality.

Shleifer, A. And Vishny, R. W. 1986. Large stockholders and corporate control. *Journal of Political Economy*, 94, 3, 461-488

Srinivasan, S. 2005. Consequences of financial reporting failure for outside directors: evidence from accounting restatements and audit committee members. *Journal of Accounting Research* 43 (2): 291-334.

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

Zhang, I.X. 2007. Economics concequences of the Sarbanes-Oxley Act of 2002. *Journal of Accounting and Economics 44, 74-115*.

Zhizhong. H., Zhang J., and S. Yanzhi, and X. Wenli. 2011. Does corporate governance affect restatement of financial reporting? Evidence from China. *Nankai Business Review International*, Vol. 2 Iss3 pp. 289 – 302.