

**REAL AND ACCRUALS EARNINGS MANAGEMENT
AND VALUE RELEVANCE OF ACCOUNTING
INFORMATION AMONG INDONESIAN
LISTED COMPANIES**

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UNIVERSITI SAINS MALAYSIA

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AND VALUE RELEVANCE OF ACCOUNTING
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LISTED COMPANIES**

by

IMAM SUBEKTI

**Thesis submitted in fulfillment of the
Requirements for the “degree” of
Doctor of Philosophy**

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Dedicated with all my affection to:

Diana Puspitasari, my beloved soul mate.
Thanks for your all devotions, extraordinary sacrifices and unceasing prayers.

Erbakhan Zakaria Kusuma, my young gallant & smart prince.
Thanks for your patience and encouragement.
Hopefully, you are able to reach your dream and hope at the top of ladder.

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Sincere your affection will never be avenged.
Oh God, give the most beautiful everything to them.

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LIST OF ABBREVIATIONS

Abn. CFO=	Abnormal cash flow from operation
Abn. DISCR=	Abnormal discretionary expenses
Abn. PROD=	Abnormal production cost
$ACC_{i,t}$ =	Total accrual for firm i in year t
$ACCOMP_{i,t}$ =	Total accruals matched performance for firm i in year t
$CFO_{i,t}$ =	Operation cash flow for firm i in year t
$DACCOMP_{i,t}$ =	Discretionary accruals matched performance for firm i in year t
DISCR=	Cash discretionary expenses
$EARN_{i,t}$ =	Earnings before extraordinary items for firm i in year t
INC_{it} =	Net Income for firm i in year t
$INT_{i,t}$ =	Intangibles assets for firm i at end year t
$Log.TA_{j,t-1}$ =	Logarithm of total assets for firm i in year t-1
$LTACC_{i,t}$ =	Long-term accrual for firm i in year t
$LTACCOMP_{i,t}$ =	Long-term accruals matched performance for firm i in year t.
$LTDAMP_{i,t}$ =	Long-term discretionary accruals matched performance for firm i in year t.
$PPE_{j,t}$ =	Property, plant and equipment for firm i in year t
PROD =	Cash production cost
$STACC_{i,t}$ =	Short-term accrual for firm i in year t
$STACCOMP_{j,t}$ =	Short-term accruals matched performance for firm i in year t
$STDAMP_{i,t}$ =	Short-term discretionary accruals matched performance for firm i in year t
$TA_{j,t-1}$ =	Total assets for firm i in year t-1
$\Delta AR_{i,t}$ =	Accounts receivable at end year t less accounts receivable at end year t-1 for firm i
$\Delta AP_{i,t}$ =	Accounts payable at end year t less accounts payable at end year t-1 for firm i
$\Delta INV_{i,t}$ =	Inventory at end year t less inventory at end year t-1 for firm i
$\Delta OCA_{i,t}$ =	Other current assets at end year t less other current assets at end year t-1 form firm i
$\Delta REV_{j,t}$ =	Revenues in year t less revenues in year t-1 for firm i
$\Delta REC_{j,t}$ =	Account receivables in year t less account receivables in year t-1 for firm i
$\Delta OCL_{i,t}$ =	Other current liabilities at end year t less other current liabilities at end year t-1 for firm i
$\Delta TXP_{i,t}$ =	Tax payable at end year t less tax payable at end year t-1 for firm i
REV=	Total revenues/ sales t
ROA =	Return on assets (Net income t/ Total assets t-1)
EPS =	Earnings per share
BVEq =	Book value of equity
PRICE =	Stock price t
Return =	(Stock price t – Stock price t-1)/ Stock price t-1

PENGURUSAN PEROLEHAN SEBENAR SERTA AKRUAN DAN KAITAN NILAI MAKLUMAT PERAKAUNAN DI KALANGAN SYARIKAT-SYARIKAT YANG TERSENARAI DI INDONESIA

ABSTRAK

Pencentusan krisis ekonomi Asia Timur tahun 1997, kelemahan dari segi pelaksanaan tadbir urus syarikat dan kesan ke atas hubungan di antara pengurusan perolehan dan kaitan/relevansi nilai maklumat perakaunan telah mendorong kajian ini dilaksanakan dengan objektif berikut: (1) untuk memeriksa sarana yang digunakan oleh syarikat awam yang tersenarai di Indonesia untuk melaksanakan pengurusan perolehan dalam usaha mengelakkan kerugian dilaporkan, (2) untuk menyelidiki hubungan di antara maklumat perakaunan (perolehan dan nilai buku ekuiti) dengan nilai firma, (3) untuk menyelidiki pengaruh amalan pengurusan perolehan ke atas relevansi nilai maklumat perakaunan. Sampel kajian ini terdiri daripada 97 syarikat awam yang tersenarai di Bursa Saham Indonesia dari tahun 1996 sehingga 2006, dengan 1164 cerapan tahun-syarikat. Regresi data panel telah digunakan untuk menguji hipotesis kajian ini. Dapatan kajian menunjukkan bahawa syarikat awam di Indonesia lebih cenderung untuk melakukan pengurusan perolehan sebenar berbanding dengan pengurusan perolehan akruan dalam usaha untuk mengelakkan kerugian dilaporkan. Aktiviti sebenar yang digunakan sebagai sarana untuk melakukan pengurusan perolehan adalah aliran tunai dari operasi, kos pengeluaran, dan kos diskretionari. Sementara itu, amalan pengurusan perolehan akruan pula dilakukan melalui akaun akruan jangka panjang. Dapatan kajian juga menunjukkan perolehan dan nilai buku ekuiti masih relevan untuk mengukur nilai syarikat. Amalan pengurusan perolehan

menunjukkan hubungan negatif dengan relevansi nilai maklumat perakaunan. Kajian juga mendapati bahawa pihak pengurusan cenderung untuk mengurangkan kedua-dua belanja tunai dan akruan semasa krisis ekonomi. Sebaliknya, pengurusan perolehan dikendalikan melalui peningkatan aliran tunai dari operasi dan kos pengeluaran selepas krisis ekonomi. Dari perspektif teori, kajian ini menyokong ramalan teori perakaunan positif mengenai motivasi pengurus dalam penglibatan pengurusan perolehan iaitu untuk tujuan mengkomunikasikan maklumat kepada para pelabur. Analisis sensitiviti yang dilakukan melalui pelarasan logaritma terhadap model pengurusan perolehan dan pengiraan nilai ambang perolehan sesaham dengan penggunaan dua jenis nilai matawang memberi sumbangan literatur dari segi metodologi kajian. Kajian ini membuktikan secara empirikal bahawa syarikat yang tersenarai di Bursa Saham Indonesia terlibat dalam pengurusan perolehan dengan cara memaksimumkan keuntungan dalam usaha mengelakkan perolehan negatif (kerugian). Ini bermakna pihak berkuasa perlu memperkenalkan ukuran tambahan melalui aktiviti pengawalan yang berterusan untuk menyekat kelakuan pengurusan yang oportunistik dengan lebih berkesan di samping memperbaiki integriti proses pelaporan kewangan.

REAL AND ACCRUALS EARNINGS MANAGEMENT AND VALUE RELEVANCE OF ACCOUNTING INFORMATION AMONG INDONESIAN LISTED COMPANIES

ABSTRACT

The outbreak of the 1997 East Asian financial crisis, weak corporate governance practices in Indonesia and their impact on the relations between earnings management and value relevance of accounting information have motivated the present study to pursue the following objectives: (1) to examine the tactics employed by Indonesian public listed companies to conduct earnings management in the attempt to avoid reporting losses, (2) to investigate the relationship between accounting information (earnings and book value of equity) and firm value, and (3) to investigate the effect of earnings management practices on the value relevance of accounting information. The sample of this study comprises 97 public companies listed in the Indonesian Stock Exchange over the period of 1995 to 2006 with 1164 firm-years observations. Panel data regression was employed to test the hypotheses. The results show that Indonesian public companies tend to perform real earnings management rather than accruals earnings management to avoid reporting losses. Real activities which are used as vehicle to perform earnings management are cash flow from operation, production costs, and discretionary expenses. On the other hand, accruals accounts are managed through the use long-term accruals. The results also reveal that earnings and book value of equity are still relevant in measuring firm value. Earnings management practices are negatively related to the value relevance

of accounting information. The study also found that during the economic crisis, management tends to reduce both cash and accrual expenses. On the contrary, earnings management is performed through increasing of cash flow from operation and production costs after the crisis. From the theoretical perspective, the study supports the prediction of positive accounting theory regarding the motivation to engage in earnings management among managers i.e. to communicate information to investors. The sensitivity analysis on the application of the logarithm adjustment to the earnings management model and the computation of the earnings per share threshold using two different currencies contribute to the literature with respect to research methodology. This study provided empirical evidence that companies listed in Indonesian Stock Exchange engaged in earnings management through income maximization in order to avoid negative earnings (losses). This suggests that authoritative bodies may need to introduce additional measures through ongoing regulatory activities to more effectively restrict the opportunistic behaviour of management and to improve the integrity of the financial reporting process.

CHAPTER 1

INTRODUCTION

1.1 Background of research

Poor corporate governance is widely perceived as one of the structural weaknesses responsible for the outbreak of the 1997 East Asian financial crisis among the developing countries ([Huang, Morck, & Yeung, 2004](#)). The crisis, as indicated by the enormous depreciation of the exchange rates and a sharp decline of the stock markets, severely impacted many South-East Asian countries, including Indonesia. As a result of the crisis, the Indonesian currency depreciated tremendously and as a result, many businesses, particularly those in the banking sector, collapsed in 1997 ([Tabalujan, 2002](#)).

A study conducted by Johnson, Boone, Breach & Friedman ([2000](#)) on 23 Asian countries pointed to the poor application of corporate governance, particularly the effectiveness of protection for minority shareholders as one of the main causes of the regional financial crisis. The findings of the study revealed that Indonesia obtained the lowest scores in terms of corporate governance. The study attempted to evaluate corporate governance based on four broad dimensions namely (1) the efficiency of the judiciary, (2) corruption, (3) the rule of law, and (4) the general assessment of corporate governance. The first three of the dimensions are closely associated with the effectiveness of protection for minority shareholders, particularly those related to the act of expropriation by managers ([Johnson, Boone, et al., 2000](#)).

Following the financial crisis, the Indonesian government attempted to improve its corporate government system through the introduction of a number of legal reforms such as Anti-Corruption Act in 1999, the establishment of the National

Committee Governance Policy in 2001, the privatization of state owned enterprises in 2003, guidelines for good corporate governance conduct, guidelines for committee audits, and guidelines for independent commissioners in 2004 ([Kaihatu, 2006](#)).

Table 1.1

Corporate governance quality score of several East Asian countries

Country	Rules & Regulation	Enforcement	Political & Regulatory	IGAAP	CG Culture	Score 2004	Score 2003
<u>Panel A. Scores for the years 2004 and 2003(comparative)</u>							
Singapore	79	65	81	95	58	75	77
Hong Kong	66	58	75	90	46	67	66
India	66	58	63	75	50	62	66
Malaysia	71	50	50	90	46	60	55
South Korea	61	50	50	80	50	58	55
Taiwan	63	46	63	70	35	55	58
Thailand	61	38	50	85	35	53	46
Philippines	58	31	50	85	31	50	37
China	53	42	50	75	23	48	43
Indonesia	53	27	38	60	27	40	32
<u>Panel B. Score for the year 2010</u>							<u>Score</u>
Singapore	65	60	69	88	53		67
Hong Kong	59	63	67	80	54		65
Japan	45	53	62	75	53		57
Taiwan	50	47	56	78	46		55
Thailand	56	42	54	73	49		55
Malaysia	49	38	60	80	32		52
India	46	36	54	63	43		49
China	47	36	56	75	30		49
South Korea	43	28	44	78	33		45
Indonesia	39	28	33	67	32		40
Philippines	35	15	37	75	25		37

Source: CLSA Media Release ([2004](#), [2010](#)).

Despite considerable efforts taken by the Indonesian government to improve the corporate governance system of the country, Table 1.1 shows that Indonesia is still lagging behind other countries in the region with regards to the implementation of good corporate governance practices. The survey results published by Credit Lyonnais Securities Asset (CLSA) on the implementation of corporate governance

among Asian countries over the years of 2003 to 2004 revealed that Indonesia obtained the lowest rank among the East Asian countries with a total score of 40 and 32 in 2004 and 2003 respectively. Table 1.1 presents the findings of the survey.

As depicted in the panel B of Table 1.1, the results show that when the same evaluation was repeated for the year 2010 on the application of the principles of corporate governance, no significant difference was noted for Indonesia. In particular, although Indonesia has improved in its ranking by one position, a further analysis showed that the total score obtained was the same as the year 2004. In substance, this suggests that the implementation of the principles of good corporate governance was not effective in bringing meaningful changes to the Indonesian corporate practices.

The findings are consistent with the results of a survey conducted by Political and Economic Risk Consultancy (2006) on the perception of corporate governance standards. The results revealed that Indonesia ranked 10 among 12 Asian countries with a score of 7.5 which is rated as poor in terms of corporate governance standard ([Economic Development Bank \(EDB\), 2007](#)). Indonesia's score reflects that the movement of corporate governance in Indonesia (introduced in 1999 with the establishment of a Code for Good Corporate Governance) still failed to significantly enhance the corporate governance practices among Indonesian companies. In summary, the above discussions suggest that the quality of Indonesia's corporate governance is poor.

Previous studies conducted by resesarchers in developed countries documented significant relationship between corporate governance mechanisms and several earnings quality measurements such as earnings management ([Dechow, Sloan, & Sweeney, 1996](#); [Dhaliwal, Naiker, & Navissi, 2006](#); [Klein, 2002](#); [Siregar &](#)

[Bachtiar, 2004](#); [Xie, Davidson Iii, & DaDalt, 2003](#)), information content of earnings ([Niu, 2006](#); [Petra, 2007](#)), and accounting fraud ([Beasley, 1996](#)). The findings of these studies generally suggested that poor implementation of corporate governance provides opportunities for managers to manipulate accounting information by engaging in earnings management, accounting fraud and other activities which then resulted in an adverse impact to the quality of accounting information.

Richardson ([2000](#)) found a systematic relationship between the magnitude of information asymmetry and the level of earnings management. The magnitude of information asymmetry affects the magnitude of earnings management practiced by managers. It is found that when information asymmetry is “high”, stakeholders encounter more difficulties in getting access to the information they need to detect earnings manipulation. Thus, they may suffer from huge financial losses as a consequence of relying on unreliable earnings information for investment decision-making.

1.1.1 Opportunities to engage in earnings management in Indonesia

As an emerging capital market, many of the listed companies in Indonesia have evolved from the traditional family owned enterprises with highly concentrated ownership structure ([Claessens, Djankov, & Lang, 2000](#)). In the context where firms have a controlling block of shares held by the major shareholders, the key agency problem is between the controlling (majority) and minority shareholders ([Ismiyanti & Mahadwartha, 2008](#)). In contrast, the ownership structure in developed countries is dispersed and hence restricted the occurrence of agency problems between the majority and minority shareholders. As a result, the agency problem in developed countries is between shareholders and managers ([Jensen & Meckling, 1976](#)).

Under the condition of a highly concentrated ownership structure, it is argued that the controlling shareholders effectively possess greater control rights than the control rights provided through their voting shares since they are also involved in the management decisions ([La-Porta, Lopez-de-Silanes, & Shleifer, 1999](#)). Concentrated share ownership thus creates opportunities for controlling shareholders to expropriate the resources of an entity. Expropriation is a process of using one's control rights to maximize their welfare through the distribution of wealth from others to himself ([Claessens, Djankov, Fan, & Lang, 1999b](#)). Expropriation is an earnings management tactic conducted by management benefitting the controlling shareholders.

Furthermore, La-Porta et al. ([1999](#)) state that the monitoring function will be difficult if managers are part of the majority shareholders when their ownership increases to a certain level. If one's voting shares have reached a certain threshold, then one can have a full control and tends to steer the company to accomplish one's personal objectives ([Shleifer & Vishny, 1997](#)).

As an agent, a manager has access to information before it is published to the public. It is argued that the quality of published information will be higher if there is no separation between owners and managers. The logic behind this idea is straightforward. If managers are also the owners, there is no incentive for them to release information that will not reflect the true economic condition of the entity. This is because the issuer and the users of the information are the same party. However, if there is a concentration of ownership in a single person/group and only a small portion of stocks are owned by other stockholders, the quality of earnings information may then be reduced due to the act of the managers retaining some information for their self-interest.

In addition, it is also argued that to engage in expropriation in countries that adheres to the civil law is easier compared to countries which practise common law legal system ([Johnson, Porta, Silanes, & Shleifer, 2000](#); [La-Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000](#)). Under the Common law system, accounting standards and policies are more stringent and the protection of the rights of shareholders and creditors is greater with the implementation of various contract systems ([Graff, 2008](#); [La-Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998](#)). It is perceived that a country like Indonesia which has its legal tradition originated from the civil law has relatively weaker development in its capital market and various financial institutions as compared to those countries which have legal environment rooted from the common law system.

Johnson et al. ([2000](#)) attempted to rate the level protection for non-controlling shareholders with a scale of one to five (with five as the highest value that describes the highest non-controlled shareholders protection and one indicating the least protection). The findings of their study revealed that, among the 23 countries, the protection for noncontrolled shareholders by Indonesia was very weak. Such condition may allow the controlling shareholders to expropriate the non-controlling shareholders.

A number of suspected cases related to expropriation in Indonesia have been published in the magazine Trust ([2003](#)). Two of such cases are discussed below: The first company is PT. Barito Pacific Timber Tbk, which acquired 60% of PT. Enim Musi Lestari. PT. Barito Pacific Timber Tbk.'s financial report at 2001 expressed no opinion or disclaimer due to a transaction that is not accompanied by endorsement in 1998. The transaction value was US\$ 204 million in cash. As the transaction did not

obtain the approval of its minority shareholders, the money was used as a down payment for the earlier acquisition process.

The second case involves the case of Robert Tantular as a controlling shareholder of PT. Bank Century Tbk which disbursed credit to PT. Wibowo Wadah Rezeki and PT. Accent Investment Indonesia. The majority voting shares of these companies are owned by Robert Tantular ([Kontan, 2009](#)). PT. Bank Century Tbk has disbursed credit with a value of 121.3 billion Rupiah to PT. Wibowo Wadah Rezeki Tbk. and 397.97 billion Rupiah to PT. Accent Investment Indonesia over the years 2008 and 2009 without going through proper precedures. The impact of these transactions is that PT. Bank Century Tbk. went into financial distress, as a result, many customers failed to recover their deposits from the bank.

1.1.2 Corruption, collusion, and nepotism in Indonesia

An important phenomenon that is unique to the Indonesian context is related to its widespread corrupt practices. Corruption, collusion and nepotism have become a norm to most Indonesians. Even the general public who live in remote villages understand the terms and aware of such practices as essential means to make things progress and get things done. Even though corruption and knotty bureaucratic system are perceived as barriers to achieving a good political, economic and social justice, however, despite much efforts taken by various regulatory and voluntary parties to instill a change, the outcomes were far from desired.

In fact, corrupt practices have become a culture in Indonesia. They have been conducted in various forms and have occurred in all aspects of life. As the victims of such practices, individuals, organizations, businesses, government agencies and communities are burdened with the consequences of corrupt practices. For instance,

businesses and society incurred additional investment costs and operating expenses due to extra bribery charges. These levies boost up production costs and demand higher selling prices for break even, consequently the competitiveness of the companies in the markets was adversely affected. At the same time, it also reduces the ability of employers to pay higher wages to their employees and causes high uncertainty in financial planning. In some cases, companies end up suffering losses due to all these hidden costs. As an attempt to avoid reporting negative earnings in order to secure their jobs, managers are motivated to engage in earnings management. In addition, the poor business culture also creates vast opportunities for wealth expropriation by managers. To cover up losses from misuse of organization's resources to fulfill their private benefits, managers may be prompted to engage in earnings management to avoid reporting losses.

1.1.3 Value relevance of accounting information in Indonesia

The conduct of earnings management is expected to have important impact on the value relevance of accounting information as such act may falsify the information published in the financial statements and thus distorted the credibility of these reports. Even though researches on the value relevance of accounting information conducted in Indonesia and other developing countries generally found that accounting numbers are relevant to measure firm value ([R. Graham, King, & Bailes, 2000](#); [R. C. Graham & King, 2000](#); [S. M. Sari, 2004a](#); [Suwardi, 2005](#); [Cynthia A. Utama, Sembel, & Utama, 2001](#)), studies also noted that value relevance of accounting information among Asian countries have shown fluctuating patterns of movements over different periods due to various causes such as financial crisis, negative earnings, accounting scandals and violation of regulations in the capital

market. Overall, it is noted that these factors have negatively affected the value relevance of accounting information.

A number of studies on value relevance of accounting information conducted in Indonesia reported consistent results which indicated that accounting information in Indonesia is relevant. These included study conducted by Jati ([2003](#)) using investment opportunity set (IOS) as the moderating variable; study on industrial sector, direction and transitory earnings conducted by Pinasti ([2004](#)); study on dividends, accruals quality, and firm size conducted by Anggono & Baridwan ([2003](#)); and the study on initial public offerings conducted by Gumanti ([2004a](#)).

Researches on value relevance of accounting information have continued to develop following the development of circumstances which affect the information environment such as changes in accounting standards, earnings management and economic conditions in both developed and developing countries. Kadri, Aziz, & Ibrahim ([2009](#)) investigate the differences in value relevance of book value and earnings between two different financial reporting regimes i.e. during MASB and FRS period in Malaysia. The results of the study suggest that book values are value relevant for both regimes but earnings are value relevant for MASB period and not value relevant for FRS period. This means that the value relevance of earnings is significantly affected by the transition to the IFRS financial reporting regime. Book values, however, does not behave in the same manner.

Another study which investigated the value relevance of accounting information is conducted through a test which aggregates book value and earnings versus a test which disaggregates book value and earnings among Malaysian high-technology firms ([Kadri, Ibrahim, & Aziz, 2010](#)). The results of the study show that the explanatory powers of book value and earnings vary, book value reported a

decreasing trend, while earnings depicted an increasing trend. The results also suggest that when book values and earnings are disaggregated, they could provide better explanations to the variations in the market values than when they are aggregated.

The association among the violation of regulation, earnings management practices and value relevance of accounting information has not been examined by various researchers even though managers in Indonesia are suspected to engage in earnings management practices as described in section 1.1.1. Furthermore, the accounting reporting violations occurred in the Indonesia capital markets (as depicted in Table 1.2 and Table 1.3 below) also raised questions about the value relevance of information presented by some of the Indonesian listed companies. Therefore, research on the value relevance associated with earnings management practices is essential to enhance the understanding of the subject matter and to contribute to the literature.

Table 1.2
Violations against Capital Market Regulation (2004 – 2008)

Year	Number of violation cases against capital market regulation	Number of violation cases that lead to criminal acts	Aggregate amount of fine
2004	313	7	IDR 9,085 Million
2005	160	3	4,747 Million
2006	140	5	6,664 Million
2007	136	2	6,730 Million
2008	137	2	8,415 Million

Source: Annual Reports of Indonesia Financial Institution and Capital Market Supervisory ([Bapepam-LK, 2008a](#))

Violation cases against capital market regulations related to issuer and public company disclosure inter-alia consist of violation of transactions related to conflict of interests between managers and investors; and conflict of interests in inter-affiliated companies. Other cases are manipulation of some important and material transactions such as expropriation conducted by managers, incomplete disclosure of the particulars of shareholders, concealment of material facts of information that must be disclosed to the public, inappropriate financial statement presentation, and the abuse of funds generated from public offers.

Whereas, violation cases which lead to criminal acts related to securities transactions inter-alia consist of alleged market manipulation, false trading, insider trading, and deception. In addition, the following data reflects the degree of transparency of information based on the level of timeliness of financial report submission and the level of unqualified opinion auditor reports among Indonesian public companies.

Table 1.3

Level of financial report, use of IPO fund report submission timeliness, and level of unqualified opinion auditor report for Indonesian public companies (2004-2008)

Year	Level of timeliness of annual financial report	Level of timeliness semiannual financial report	Level of timeliness use of IPO fund report	Level of unqualified opinion
2004	80 %	76%	79%	91%
2005	83%	83%	80%	93%
2006	76%	82%	82%	94%
2007	85%	83%	90%	94%
2008	70%	82%	90%	92%

Source: Annual Reports of Indonesia Financial Institution and Capital Market Supervisory/ ([Bapepam-LK, 2008a](#))

As depicted in Table 1.2 and 1.3, violation against capital market regulations includes late submission of annual reports, semi-annual financial reports, use of IPO fund reports and qualified opinions made by auditors. The above evidence showed that the compliance level of good corporate governance practices among Indonesian public companies still needs to be improved. Such condition can be detrimental to the users of financial statements. A weak application of corporate governance can encourage management to act for his own interest and this can seriously harm other stakeholders.

1.1.4 Earnings management and value relevance of accounting information

The economic crisis experienced by Indonesia has also raised a number of questions pertaining to the reliability of information provided by financial statements. This is reported by the United Nations Conference on Trade and Development (UNCTAD) in March 1999 ([Media Akuntansi, 2004](#)). In particular, the economic crisis has prompted some of distressed firms to engage in earnings management in order to avoid reporting negative earnings or losses. The act of management to meet earnings target and to avoid financial losses by managing reported earnings has caused deterioration of the reliability of earnings information and a decrease in the value relevance of accounting information.

Governance system play an important role in the financial reporting process. As suggested by prior researches, rules and regulations formulated to protect investors is a key institutional factor affecting the corporate policy choices ([La-Porta, et al., 2000](#); [Shleifer & Vishny, 1997](#)). These researchers found that the protection level performed by institutions are associated with the usefulness of accrual-based accounting information. The level of protection imposed by the capital market

supervisory agency plays a role in reducing the level of manipulation that can be conducted by the managers and controlling shareholders through accrual transactions. Several international studies ([Ali & Lee-Seok, 2000](#); [Leuz, Nanda, & Wysocki, 2003](#)) provide evidence on the association between several earnings quality measurements and the degree of protection to investors from the expropriation by controlling shareholders and managers. These studies assert that the characteristics of earnings are affected by the degree of investors' protection.

Indonesian accounting scandals entangling the accounting profession including LIPPO Bank and KIMIA FARMA which occurred in 2002 ([Kompas, 2002](#); [Koran Tempo online, 2003](#); [Pontianak Post, 2003](#)). The third quarterly 2002 financial statements of LIPPO Bank released to the public (30 September) were different from the financial statements submitted to Jakarta Stock Exchange (27 December). The difference is due to decrease of assets value and book value of equity by Rp 1.372 quintillion and Rp 1.392 quintillion respectively or 47 percent from the previous value.

In the case of KIMIA FARMA, its financial statements of for the year ended 31 December 2001 show that net income was inflated by Rp 32.668 billion. The financial statements were supposed to report Rp 99.595 billion net income instead of Rp 132 billion. This action is classified as information astray. This is caused by accounting negligence as well as manipulation of the stock prices.

The above accounting scandals demonstrated examples of real earnings management in action. This evidence shows that a company's financial statements; particularly, its earnings, is vulnerable to manipulation by managers. Based on the above arguments, it is critical to gain an in-depth understanding about the relations between earnings management and the value relevance of accounting information, in

particular, whether earnings management caused a decrease in the value relevance of accounting information.

1.2 Research problem

The discussions presented in the previous sections attempted to highlight a few issues pertaining to the phenomena observed from the Indonesian capital market. First, the country has taken serious measures to improve its corporate governance system to deal with those weaknesses related to its capital markets as identified by various stakeholders following the 1997 Asian financial crisis. Secondly, findings from a number of studies suggest that the implementation of the governance system is poor among Indonesian listed companies. This means that although the regulators have introduced high quality standards which are at par with other developed nations, the level of compliance has made all such efforts rather useless and meaningless. Such phenomena draw concerns about the possibilities of managers engaging in misconduct that are harmful to investors. Studies from developed nations suggest that poor corporate governance is associated with earnings management and has an adverse impact on the quality of accounting information. In addition, anecdotal evidence from Indonesia has also provided evidence about suspected cases of expropriation by managers. This suggests that earnings management practices among Indonesian companies appear to be an area that warrants further investigation.

The concern of earnings management practices among Indonesian public companies is reasonable. This is because the level of perceived standard on disclosure and transparency in Indonesia is still low or poor. The low protection of non-controlling shareholders as well as the weak implementation of corporate governance may cause managers to be opportunistic by engaging in earnings

management, hence, earnings management researches are essential to provide useful insights about the conditions in Indonesia. In relations to that, a further issue which may arise is the value relevance of accounting information prepared under such reporting environment which is characterised as lacking of strong enforcement of regulations that may “facilitate” earnings management activities.

The relationship between earnings management and value relevance of accounting information can also be explained through earnings quality. Lo ([2008](#)) argues that earnings management is associated with earnings quality. Lo ([2008](#)) also states that highly managed earnings have low quality. It means that earnings management conduct will reduce earnings quality i.e. reliability of earnings. The relevance of accounting information in firm valuation can be affected by market's insight of the reliability of the information ([Whelan & McNamara, 2004](#)). The perceived lack of earnings reliability may cause the market to place less reliance on earnings in the valuation process. This is supported by the evidence observed between discretionary accruals and stock price (Rangan, 1998; Teoh et al, 1998a; 1998b) which reveals that firms with higher level of discretionary accruals prior to stock issues tend to have poorer post-issue stock price performance. This suggests that the conduct of earnings management negatively affect value relevance of earnings.

Studies on the relationship between earnings management and value relevance of accounting information have been widely conducted in the U.S. and other developed countries. These studies attempted to examine earnings management using discretionary accruals ([Gul, Leung, & Srinidhi, 2000, 2003](#); [Marquardt & Wiedman, 2004](#); [Whelan & McNamara, 2004](#)). Gul et al. (2002, 2003) show that earnings-return relationship (value relevance of earning is affected positively by

growth opportunity and negatively by debt size. These studies also find that discretionary accruals improve the value relevance of earnings in firms with high growth opportunity. Furthermore, Whelan & McNamara (2004) demonstrated that earnings management via long-term discretionary accruals has a greater impact on value relevance of earnings and book value than via short-term discretionary accruals. Meanwhile, Marquardt & Wiedman (2004) find that earnings management impairs the value relevance of accounting information as reflected in stock price and stock return.

The present study attempts to investigate the relationship between earnings management and value relevance of accounting information through five proxies of earnings management namely abnormal cash flow from operation, abnormal production cost, and abnormal discretionary expenses (as real earnings management proxy), short-term discretionary accruals and long-term discretionary accruals (as accruals earnings management proxy). As Indonesia is an emerging market, such an attempt is believed to be able to provide a more thorough understanding about the tactics engaged by Indonesian companies in earnings management. Such approach has not been used by studies conducted in developed as well as developing countries. Hence, the present study would contribute to the literature based on the comparisons among those tactics.

1.3 Research questions

Based on the research problem discussed above, the research questions are stated as follows:

1. What kind of earnings management tactics are employed by Indonesian public companies to avoid reporting negative earnings?

2. What is the relationship between accounting information (earnings and book value of equity) and firm value as measured by stock price and return?
3. What is the effect of each earnings management measurement (proxy) on value relevance of accounting information?

1.4 Research objectives

The objectives of the research are:

1. To examine the tactics employed by Indonesian public companies to conduct earnings management to avoid reporting negative losses.
2. To investigate the relationship between accounting information (earnings and book value of equity) and firm value as measured by stock price and return.
3. To investigate the effect of each pattern (proxy) of earnings management on value relevance of accounting information.

1.5 Significance of the study

This section discusses about the contribution of the research in several aspects. Firstly, this research attempts to examine the behavior of earnings management proxy that is. real earnings management proxy and accruals earnings management proxy. Real earnings management proxy includes abnormal cash flows from operations, abnormal production cost, and abnormal discretionary expenses. Accruals earnings management proxy includes short term and long term discretionary accruals. The use of both real and accruals earnings management proxy employed by the present research has not been conducted in previous studies. Generally, previous studies only employed accruals earnings management proxy in an attempt to examine its relationship with value relevance of accounting information.

Secondly, the use of earnings per share (EPS) as a basis to identify samples engaging in earnings management has not been widely tested. The present study introduces an alternative in identifying samples engaging in earnings management that is using EPS distribution. This is different from previous studies which used return on assets (ROA) distribution. EPS as bases in identifying the samples is more appropriate for the Indonesian context because the main agency problem in Indonesia is between majority stockholders and minority stockholders. This implies on information needed by minority investors in Indonesian stock market. Minority investors need a simple benchmark to evaluate a firm's performance with the cost of information processing due to the availability of abundant information. The EPS metric receives promulgate and wide coverage by the media. The analysts can create a better prediction of future firm value because they can base their assumption on the EPS number. The analysts evaluate a firm's progress based on whether a company hits the EPS consensus ([J. R. Graham, Harvey, & Rajgopal, 2005](#)).

Practically, the results of this research will contribute to parties such as regulators (accounting standard setters), and investors in the Indonesian stock market. The present research relates each earnings management proxy to value relevance of accounting information in terms of earnings and book value of equity. Hence, the research result will be able to explain more in depth the impact of various earnings management practices engaged by management on value relevance of accounting information. The information provides benefit (input) for regulators to improve transparency and disclosure principles, in particular, principles related to accounting manipulation. Accounting manipulation is an avenue where managers or controlling shareholders take on opportunistic actions that can impair other parties, such as minority shareholders.

Furthermore, the research result of this study will be able to provide highlight information to investors, analysts, accounting and auditing professionals. The findings of the present research indicate that the presence of earnings management is able to deteriorate the value relevance of accounting information. Thus, a firm's propensity to manage earnings is relevant information that should be considered in the firm valuation process.

1.6 Organization of the chapters

This thesis consists of six chapters. The beginning chapter presents a brief background of the study which explains and justifies the motivations of the present study. This chapter also reviews the relationship between corporate governance and earnings management, examines the relationship between earnings management and value relevance of accounting information, and presents the problem statement, research questions, objectives, and significance of the study.

Chapter two describes the environment and the characteristics of Indonesian businesses with regards to the corruption and bribery activities in Indonesian's business, regulatory environment to eradicate in Indonesia, characteristics of Indonesian's large companies, and the Indonesian Stock Exchange. Chapter three reviews the literature and previous studies of earnings management, positive accounting theory, value relevance of accounting information, previous evidence on the relationship between earnings management and value relevance of accounting information, and theoretical framework and development of hypotheses.

Chapter four illustrates the research methodology employed to answer the research questions. This includes the population and sampling procedures, the definition and measurement of variables, data source and type of data, and statistical

analysis. Chapter five presents the data analysis and discussion. It begins with the illustrations of the descriptive statistics on the research data and variables. Then, it is followed by the results of the hypotheses testing, sensitivity analysis, and assessment on the assumptions of the statistical tests. This chapter ends with a discussion of the findings and summary.

Chapter six consists of conclusion. It begins with the recapitulation of study and followed by discussion about the implications of the research findings and the contribution of the study both theoretically and practically. The chapter concludes with the limitations of the study and suggestions for future research.

CHAPTER 2

OVERVIEW ON BUSINESS ENVIRONMENT IN INDONESIA

2.1 Introduction

This chapter provides an overview about the background and the development of the business environment and the capital market in Indonesia. The first section (section 2.2) describes the Indonesian's business environment. The second section (section 2.3) explains development and the general characteristics of Indonesian's companies regarding the ownership structure and related problems. The third section (section 2.4) provides an overview of the Indonesian stock market in relations to the level of information efficiency. The last section (section 2.5) concludes with a summary of the chapter.

2.2 An overview of Indonesian's business environment

Indonesian business environment is plagued by poor infrastructure, weak institutions and corrupt practices which occur in the government bureaucracy. Despite ongoing anti-corruption drive, Indonesia is poorly ranked at the 100th position (out of 182) in the 2011 Corruption Perception Index published by Transparency International ([Transparency International, 2011](#)). Moreover, aside from the problems of corruption, poor infrastructure, excessive bureaucracy and security risks due to criminal activities also undermine the country's business environment. Fortunately, commitment by the government and the respective regulatory bodies to continually improve Indonesia's business environment, and its recent transition to democracy has significantly improved the long-term prospects for doing business in the country.

In Indonesia, corruption is pervasive, afflicting many private and public institutions. The media regularly covers high-level corruption cases while successful prosecutions are few and far between. The World Bank estimates that corruption can add up to 20% of the cost of doing business in Indonesia ([Anonim, 2011](#)). The entire judicial system is affected, with the police and judges alleged to regularly supplement incomes from bribes and commissions. For instance, the customs service is an area where corrupt practices are said to flourish. In an attempt to clamp down corruption in the customs department, the government has issued regulations which require Indonesian importers to pay their import duties and taxes directly to banks appointed by the government. This policy, however, only achieved moderate success.

The lack of clarity in regulations provides ample room for opportunistic doings. The lack of transparency and a surfeit of bureaucratic red tape are among investors' biggest complaints. Corruption is rampant in Indonesia, which has been widely recognised as the primary obstacle in attracting foreign investments. Government's intervention is necessary to improve the country's decrepit infrastructure.

2.2.1 Corruption and bribery activities among Indonesian Businesses

The development of businesses in Indonesia has been inextricably linked to political influence and patronage for years. It has been virtually impossible to make progress on any major projects without the right level of influence from senior persons in the relevant government departments and close relationship with the politicians. It is widely believed that bribery is widespread among business organizations in Indonesia (Kuncoro, 2004, 2006).

Bribery is not a culture that emerges recently in Indonesia. It has occurred since the rule of the Dutch government in Indonesia. Before its independence, many small kingdoms in Indonesia used to give away some of their property, which was called a tribute, to get protection from the Dutch government. The giving of such property was intended to get protection in return from the Dutch government. The Dutch government then introduced laws which stated that bribery was a criminal action ([Kartika, 2010](#)) and took some measures to eradicate such doings. Today, the culture of bribery is rooted in the whole country. It is no longer applies to the royal hierarchy, but it is also applied to the people in Indonesia. People in the country are aware, understand, and are used to it. The culture of bribery is motivated by various factors and such practice has eventually dented the government's image in the society.

Indonesia has witnessed solid economic growth in recent years. In 2010, its GDP growth reached 6.1% and is expected to be higher in 2011 ([Business Anti-Corruption, 2011](#)). Foreign investments are on the rise in Indonesia. Despite the deregulation process being successfully implemented, investors still point to corruption as the main challenge for doing business in the country. Companies continue to express concern about concessions based on personal relationship and demands of irregular fees to obtain government contracts, permits or licences. According to the 2008 Transparency International's Indonesia Corruption Perception Index and Bribery Index, companies identify the judiciary and police as the top two institutions that should be cleaned from corruption ([Business Anti-Corruption, 2011](#)).

According to a national survey on corruption cited by Credit-to-Cash Advisor in 2008, 35% of the interviewed companies reported that they avoided investing in Indonesia because of its widespread corruption. World Bank and IFC Enterprise

Surveys 2009, state that nearly 15% of the surveyed companies expect to pay bribes to public officials to “get things done” and 14% state that corruption is a major problem for doing business in Indonesia. In the World Economic Forum Global Competitiveness Report 2010-2011, the surveyed business executives point to corruption as the second most problematic factor for doing business and state that it is common for companies to make irregular payments or bribes in connection with imports and exports, public utilities, annual tax payments and awarding of public contract and licences ([Business Anti-Corruption, 2011](#)). Another factor that impeded the business climate is the decentralisation policy that led to smaller markets and restrictions on inter-regional competition, and this has encouraged collusion and anti-competitive behaviour between companies and local government in several regions.

Bribery in Indonesia typically occurs during licensing procedures. According to the U.S. Commercial Service 2010, foreign companies reported that unwarranted fees and facilitations are required in order to obtain permits and licences, to speed up processes or to win government contracts and concessions. According to World Bank’s Indonesia Rural Investment Climate Assessment 2006, service sector companies in resource rich and urban areas pay higher amounts in bribes. More established and larger companies pay lower bribes. The financial sector regulation is reported to be effective, but most of the listed companies are either family-owned or government-controlled and the corporate governance system and auditing are far below international standards ([TrustLaw, 2011](#)). Many political parties rely on the support from private companies and corporate donations. In return, these political parties will use their authority to assist the company in resolving problems such as seeking approval of operating licence from state authorities.

2.2.2 Regulatory environment to eradicate corruption in Indonesia

Indonesia is trying hard to break the long tradition of corruption by implementing transparent and accountable governance. However, former political, administrative and business elites continue to seek influence and consolidate their position in the new democratic system through informal networks. Decades of collusion between business and government have created a relatively stable, but highly unaccountable system, which does not benefit the general population.

Indonesia's recent democratised system is reported to contain some legislative and institutional shortcomings that allow for continued corrupt practices. Despite that, many legal and institutional initiatives have also been undertaken to combat corruption. This includes the establishment of the Corruption Eradication Commission (KPK, in Indonesia) under Law No. 30 of 2002. Indonesia also ratified the United Nations Convention against Corruption (UNCAC) in September 2006. These measures signify a keen ambition on the side of the government to curb corrupt practices, but in reality the enforcement lags behind. This is indicated by the reality that corruption has been exacerbated, largely as a consequence of political and administrative decentralisation initiated in 2001. According to the survey conducted by the Global Corruption Barometer 2010, 43% of Indonesians perceived that the level of corruption has increased in the past three years, and 35% considered the government efforts to fight corruption as ineffective, while 33% considered it as effective. From the same survey conducted by Transparency International in 2009, 74% of Indonesians considered the government's efforts to fight corruption as effective. This indicates that the Indonesian government has only shown limited commitment to the anti-corruption agenda in the eyes of the general public ([Business Anti-Corruption, 2011](#)).