

Corporate Governance Disclosure in Indonesia

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ABSTRACT

The purpose of this study is to examine corporate governance (CG) disclosure, particularly audit committee and internal audit disclosure, of listed firms in Indonesia. To the best of the researcher's knowledge, no previous studies have specifically examined the compliance level of listed firms in Indonesia with prevailing CG regulations, specifically related to audit committee and internal audit disclosures. We compared annual reports of 443 listed firms between 2012 and 2013 based on the regulations that govern disclosures set by the Indonesian Capital Market Authority. It was found that the level of disclosure 2012 and 2013 on CG, particularly with regards to audit committees and internal audits, was relatively low. Specifically, the level of disclosure was only 39.5% and 43.9% in 2012 and 2013 respectively. The old regulation lacked detailed requirements, meaning that the level of disclosure varied greatly across firms. The revised regulations announced in 2012 were stricter and more detailed, meaning annual reports for 2013 were expected to have richer information on the firms' CG practices. However, the level of disclosure in 2013 increased by only 4.4%. This result shows that the revised regulations did not automatically increase the level of disclosure possibly due to the fact that enforcement was not yet in place. The findings of this paper have implications for capital market regulators in particular the need to enforce the regulations with the ultimate objective of ensuring full compliance with mandatory disclosures.

Keywords: Audit committee, corporate governance, disclosure, internal audit

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INTRODUCTION

Many studies have examined the issue of disclosure (for example: Lang & Lundholm,

1993; Botosan, 1997; Sengupta, 1998). Managers have an information advantage over outsiders, about the firm's past and future economic performances (Sengupta, 1998). This information asymmetry creates agency problems. Based on the agency theory, companies disclose information to mitigate agency conflicts between shareholders and managers. Even though companies may voluntarily disclose information to outsiders, there are mandatory disclosures required by regulatory bodies.

Companies release information to the market through a number of sources, including annual reports, quarterly reports, press releases, and websites. Although there are other means of releasing information, the annual report is considered to be the major source of information for users (Botosan, 1997). Knutson (1992, p. 7), for example, states that, "at the top of every analyst's list (of financial reports used by analysts) is the annual report to shareholders. It is the major reporting document and every other financial report is in some respect subsidiary or supplementary to it." The annual report should contain useful information that will allow readers to make the right decisions, as well as make efficient use of scarce resources (Akhtaruddin, 2005).

Corporate governance (CG) is considered one of the important factors when making investment decisions, and has generated much public interest. Concerns related to public interest have motivated stock exchanges and regulators in many countries to introduce regulations that require governance-related disclosures by listed

firms (Yu, 2010). In Indonesia, for example, the Capital Market and Financial Institutions Supervisory Agency/*Badan Pengawas Pasar Modal and Lembaga Keuangan* (Bapepam-LK)¹ (now the Financial Services Authority/Otoritas Jasa Keuangan (OJK)) released several regulations pertaining to corporate governance. One example is Regulation No. X.K.6 on the Annual Reporting of Issuers or Public Companies. Under this regulation, the annual report must contain a brief description of the implementation of corporate governance in the current period. Another regulation is Regulation No. IX.1.5 on Formation and Work Performance Guidelines of the Audit Committee. Audit committees have oversight responsibility over the financial reporting process, the audit process of external and internal auditors, and compliance with prevailing laws and regulations. Regulation No. IX.I.7 also relates to corporate governance, regulating internal audit units within the corporations' organisational structures. In performing its roles, the internal audit unit works closely with the audit committee.

¹Since 31 December 2012, the role of Bapepam-LK, which is structurally under the supervision of the Ministry of Finance, has been transferred to the Financial Services Authorities/*Otoritas Jasa Keuangan* (OJK). The OJK was established by the Indonesian Government to perform regulatory and supervisory duties regarding financial service activities in banking, capital markets, and non-banking financial industry sectors.

The above-mentioned regulation on audit committees was issued in 2004, and the regulation on annual reports was released in 2006, while regulation pertaining to internal audits has existed since 2008. However, no studies have examined disclosure practices on corporate governance in Indonesia, particularly on audit committees and internal audits. Previous studies have not specifically examined mandatory corporate governance disclosure (specifically related to audit committees and internal audits) except to compare the disclosure in annual reports with a checklist based on OECD (Organization for Economic Co-operation and Development) principles of corporate governance or other checklists, which contain both mandatory and voluntary disclosures. It is therefore necessary to analyse current practices, which will provide OJK with input on the level of compliance with existing regulations. Based on this evaluation, OJK may obtain information on the current practices of audit committees and internal audits, namely whether they comply with regulations, and which areas may require improvement.

Thus, the aim of this research is to map the current practices of audit committees and internal audits based on disclosures in the annual reports of listed firms. We examine the current practices and identify the level of compliance with regulations. The results of this study will provide inputs for OJK on the listed companies' compliance with prevailing regulations.

LITERATURE REVIEW

Regulations in Indonesia

The OJK has issued Regulation No. IX.1.5 on the Formation and Work Performance Guidelines of the Audit Committee which requires all issuers or public companies to have an audit committee. The main role of an audit committee is to assist the board of commissioners in fulfilling its oversight responsibilities for compliance with the prevailing laws and regulations. The audit committee is responsible for providing professional and independent opinions and judgement over financial reporting and other reports submitted by the board of directors to the board of commissioners, as well as identifying important matters that require the board of commissioners' attention. The rule also requires firms to have an audit committee charter. This charter should be disclosed on the website of issuers or public companies. Under current regulation, audit committees should have at least three members, consisting of one independent commissioner as head of the audit committee, and at least two external independent members. Among the three members of the audit committee, one member must have a good educational background and expertise in accounting and/or finance. The audit committee is also required to hold regular meeting at least once every three months.

In 2006, OJK issued Regulation No. X.K.6 on the Submission of Issuers or Public Companies Annual Reports. Under this regulation, the annual report must contain a brief description of the implementation of corporate governance in the current period. The corporate governance disclosure should contain the following information related to the audit committee: names; working experience and the legal basis for the appointment; educational background; assignment period; independence of the audit committee; disclosure of corporate policies and their implementation; the frequency of audit committee meetings and level of attendance; and a brief description of the audit committee's activities in accordance with the audit committee charter.

Regulation No. IX.I.7 outlines the requirements for internal audit unit within a firm's organisational structure. The roles and responsibilities of internal audit units are, among others, to: (1) test and evaluate internal control and risk management systems; and (2) perform audits and evaluations of efficiency and effectiveness of the firm's operation in the areas of finance, accounting, operations, human resources, marketing, information technology and other activities. In performing these roles, the internal audit unit works closely with the audit committee.

These regulations were revised in 2012. The changes included the requirement to upload annual reports and the audit committee charter to the company's website, as well as a detailed requirement regarding the content of the internal audit charter.

Previous Studies

There have been many researches on corporate disclosure, especially in other countries. Xiao (1999) examined corporate disclosure practices in China and found a high level of compliance, largely because these requirements were mandatory. He also found many examples of voluntary disclosure, especially earnings forecasts and the supervisory board's report.

Akhtarudin (2005) investigated the extent of mandatory disclosure of 94 listed firms in Bangladesh. He found companies in general have not responded adequately to mandatory disclosure requirements, and on average, they disclosed only 44% of the mandatory requirements. This led him to conclude that prevailing regulations are ineffective monitors of companies' disclosure compliance.

Another study, on mandatory disclosure in Egypt, by Abdelsalam and Weetman (2007) examined the level of disclosure in annual reports between 1991–1992 and 1995–1996 to compare the outcome of the new Capital Market Law to the situation immediately prior to its enactment. They found that compliance with established regulation improved between 1991–1992 and 1995–1996. Samaha et al. (2012) also conducted a study on corporate governance disclosure in Egypt. They found that the levels of voluntary corporate governance disclosure were minimal; however, they found that disclosure was high for mandatory items under the Egyptian Accounting Standards (EAS). In the US, the Securities Exchange Commission (SEC) mandated

compensation disclosures, first issued in 2006. The SEC conducted a comprehensive study focusing on compensation disclosures, where it found that many firms did not fully comply with the new compensation disclosure rules (Robinson et al., 2011).

Other studies have examined the levels of mandatory and voluntary disclosure. Omar and Simon (2011), for example, showed in Jordan, there was a significant increase in the level of aggregate disclosure (average 69%) compared with findings of previous studies. They found that the extent of mandatory and voluntary disclosures was 83% and 34% respectively. These findings show that the level of mandatory disclosure is high; nevertheless, non-compliance still exists.

Devalle and Rizzato (2012) examined the consolidated financial statements of the groups listed on the Italian, French, German and Spanish stock exchanges and belonging to the main indexes of the above-mentioned markets (FTSEMIB40, CAC40, DAX30, IBEX35). They found that the quality of disclosure was very low with reference to the mandatory disclosure of IAS 36 – impairment of assets. They also found that from the sample of consolidated financial statements, only 27% reported the mandatory disclosure.

Therefore, it is clear that even though regulators in many countries require a certain level of mandatory disclosure, the level of disclosure is sometimes still quite low. Even in countries where the level of mandatory disclosure is relatively high, there are many examples of non-compliance.

RESEARCH METHOD

This study is exploratory in nature to obtain an understanding of the current disclosure practices of the corporate governance mechanisms of audit committees and internal audits. This is secondary data, collected from annual reports, especially disclosures on corporate governance, audit committees, and internal audit units. Reporting practices of audit committees, internal audit units, as well as their activities undertaken are mapped and an analysis on the compliance level of audit committees and internal audit units with OJK regulations is done. This comparison is performed using the checklist that was developed based on regulations issued by the OJK to identify the level of compliance of issuers and public companies. The results will form the basis for recommendations to the OJK for future amendments to regulations on audit committees and internal audit units.

Content analysis was performed based on the disclosure of corporate governance practices in annual reports, particularly disclosures on audit committees and internal audits. The content analysis is based on a checklist that consists of 48 items of mandatory disclosure. A score of 1 is given for each item disclosed in the annual report, so that the maximum score for each sample is 48. The checklist is prepared based on the disclosure requirements as follows:

1. Regulation No. X.K.6 regarding the Submission of Issuers or Public Companies Annual Reports, issued for the first time in 2006 and revised in 2012.

2. Regulation No. IX.I.7 regarding the Formation of Internal Audits and Guidelines on Internal Audit Charters, issued for the first time in 2008 and revised in 2012.
3. Regulation No. IX.1.5 regarding the Formation and Work Performance Guidelines of the Audit Committee, issued for the first time in 2004 and revised in 2012.

with accessible annual reports. A summary of the sample selection process is provided in Table 1.

Table 1
Sample selection

Total public firms in 2013	468
Annual reports not available	(20)
Firms newly listed in 2013	(5)
Final Sample	443

Most of the checklist items (37 items) are newly required under the revised regulations published in 2012. The remaining checklist items (11 items) are contained in the previous versions of the regulations. Based on the types of disclosure, checklist items can be classified into three main categories, as follows:

1. CG disclosures in general (3 items).
2. Audit committee disclosures (23 items).
3. Internal audit disclosures (22 items).

RESULTS AND DISCUSSION

Up to 30 September 2013, there were 468 firms listed on the Indonesian Stock Exchange (IDX). Among these, five companies were newly listed in 2013 and therefore, did not yet issued annual reports. Twenty firms were excluded from the sample, as their annual reports are not available either on their websites or that of the IDX. Following this exclusion, the final sample consisted of 443 public firms

Analysis based on checklist items, as provided in Table 2, reveals that the 2012 disclosure level of CG, audit committees, and internal audits is relatively low, 39.5% of the required disclosure. Further analysis on the types of disclosure shows that the level of internal audit disclosure, 31%, is the lowest. The low level of internal audit disclosure may be explained by the fact that the practice of internal audits is new to most public firms. The requirement for the formation of internal audits was enacted only in 2008 after the release of Regulation No. IX.I.7. Meanwhile, the requirement for the formation of audit committees was enacted earlier, in 2004, after the release of Regulation No. IX.I.5. Since the internal audit requirement is relatively new for most listed firms, the level of its disclosure is consequently still low. This finding of a relatively low level of mandatory disclosures is consistent with previous studies (such as Akhtarudin, 2005; Devalle & Rizzato, 2012).

Detailed analysis based on the year of regulation enactment shows that the level of disclosure for items under the 2012 revised versions of regulations is lower than disclosure for items that were earlier required. This indicates that corporations need time to implement the new regulations. Even though the new regulations had not yet been enforced in 2012, some new disclosure items were reported in firms' annual reports, indicating certain voluntary disclosure practices by some of the listed firms.

To further examine the compliance level of listed firms, we examine the 2013 annual reports. The results are presented

in the last column of Table 2 as well as in Figure 1. The results show that on average, there are increases in the level of disclosure, even though it is only a slight increase of 4.4% (from 39.5% in 2012 to 43.9% in 2013). Owing to the enactment of the 2012 revised regulations, which require more detailed disclosure, we expected the level of compliance to have increased, resulting in a higher percentage. The results show, however, that in 2013, when the revised regulations had already come into effect, the overall disclosure level, as well as disclosure on audit committees and internal audits, is still low.

Table 2
Disclosure level

Type of Disclosure	Checklist Items			Mean (%) Disclosure	
	Regulation Before 2012	Regulation in 2012	Total Items	Annual Reports 2012	Annual Reports 2013
Overall CG	1	2	3	58.2%	60.4%
Audit Committee	4	19	23	45.2%	50.5%
Internal Audit	6	16	22	31.0%	34.7%
Total	11	37	48	39.5%	43.9%

The level of overall disclosure in 2013 is 60.4% (an increase of 2.2% compared to 2012); the audit committee disclosure level is 50.5% (an increase of 5.3%); and the level of internal audit disclosure is 34.7% (an increase of 3.7%). The increase in audit committee disclosure is the highest compared to levels of overall and internal audit disclosure. This could be due to

audit committee regulations having been enacted in earlier years, hence, most listed firms already have audit committees in accordance with prevailing regulations, whereas the lower level of internal audit disclosure might be related to this being the most recently enacted among the three regulations.

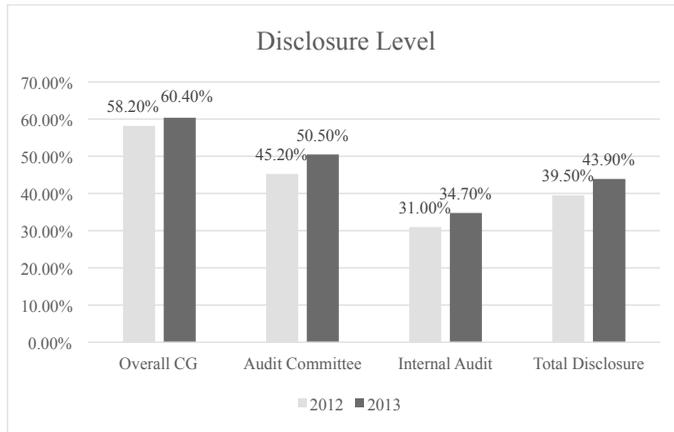


Figure 1. Disclosure level trends from 2012 to 2013

The frequency distribution of disclosure as presented in Table 3 shows that most companies (73%) have relatively low disclosure levels, i.e. less than 50%. Only 8% of the sample companies attain a disclosure level of 75% or higher. This result is consistent with the previous analysis that the overall disclosure levels of CG, audit committees, and internal audits are relatively low. These results indicate that most Indonesian public firms have not yet met the disclosure requirements of the OJK.

Further analysis of each type of disclosure is presented in Tables 4, 5 and 6. Table 4 shows that most of the sample firms (73.1% in 2012 and 73% in 2013) have disclosed the overall practice of CG in their annual report. Even though the total overall CG disclosure shows a small

increase from 58.2% to 60.4%, there is no increase in the disclosure items based on the mandatory items set forth since the regulation was first issued in 2006. This finding indicates that listed firms that are consistently maintaining their disclosure level to meet the requirements, whereas other firms that still do not fully comply with the regulations are not meeting those requirements.

Table 3
CG disclosure distribution

Distribution	Number	Percentage
< 25%	144	33%
25% – 49%	177	40%
50% – 75%	87	20%
> 75%	35	8%
	443	100%

Table 4
Overall CG disclosure

No	Disclosure Items	Requirement starts in	Disclosure Level	
			2012	2013
1	Annual report is uploaded to website at the same time of annual report submission to capital market authority	2012	54.2%	57.6%
2	Management report discloses the implementation of CG	2012	47.4%	50.6%
3	Disclosure items	2006	73.1%	73.0%
Mean			58.2%	60.4%

Even though it was not a requirement at the end of 2012, some firms (54.2% in 2012) had uploaded their annual report to their websites. Listed firms are typically large firms that have websites in order to communicate with various stakeholders, including investors that require financial information. Presenting annual reports on corporate websites does not incur additional costs for these large firms; therefore, it is expected that the voluntary presentation of

annual reports on corporate websites should be a common practice.

The requirement to upload annual reports to company websites was introduced in 2013. The percentage of listed firms that uploaded their annual reports to their websites in 2013 increased to 57.6%, an increase of 3.4% compared with 2012. This increase is relatively low and points to the fact that many firms are still not uploading their annual reports on their websites.

Table 5
Audit committee disclosure

No	Disclosure Items	Requirement begins in	Disclosure Level	
			2012	2013
1	Issuer or public company has an audit committee charter	2004	35.4%	42.7%
2	Audit committee charter is available on the company's website	2012	7.9%	15.9%
3	Audit committee charter contains at least:			
	a Duties, responsibilities, and authority	2012	33.0%	37.1%
	b Composition, structure, and membership requirements	2012	16.3%	27.0%
	c Procedures	2012	10.2%	14.7%
	d Policies on meeting	2012	13.3%	18.2%
	e System on reporting activities	2012	9.9%	17.5%
	f Whistleblower process	2012	3.8%	7.5%
	g Assignment period	2012	9.5%	16.3%
4	Audit committee consists of a minimum of three members	2004	94.6%	94.6%
5	Members of audit committee c of an independent commissioner and external members	2004	90.3%	94.2%

Table 5 (continue)

6	Audit committee is chaired by an independent commissioner	2004	94.6%	95.3%
7	Disclosure of audit committee covers:			
a	Name	2012	94.8%	94.9%
b	Professional background	2012	74.7%	78.8%
c	Working experience	2012	74.7%	79.7%
d	Assignment base	2012	25.1%	33.8%
e	Educational background	2012	75.4%	81.6%
f	Assignment period	2012	32.5%	32.9%
g	Disclosure on the audit committee's independence	2012	45.1%	43.6%
h	Policies on the frequency of audit committee meetings	2012	24.6%	30.8%
i	Actual frequency of audit committee meetings	2012	73.4%	76.7%
j	Level of members' attendance at audit committee meetings in the current year	2012	71.3%	74.6%
k	Brief description of audit committee activities in the current year as outlined in the audit committee charter	2012	29.3%	53%
Mean			45.2%	50.5%

Analysis of the audit committee disclosure level details, as presented in Table 5, shows a high level of disclosure (more than 90%) for information pertaining: names and number of audit committee members; information demonstrating that the chair of the audit committee is also an independent member of the board of commissioners; and information that audit committee members are external parties. However, only a small number of firms (7.9%) disclose their audit committee charter on their corporate website.

The audit committee disclosure items show an increase in 2013 compared with 2012. Nevertheless, this increase is also relatively small. Consistent with the findings on instances of uploading annual reports to websites, only 7.9% of listed firms had uploaded their audit committee charter to their websites in 2012. Even though there

was a twofold increase in 2013 (15.9%), the compliance level is still low. Based on the compliance level in 2012, most firms did not disclose the audit committee charter on their websites because there was no requirement for it. However, after the regulation was enacted in 2013, only 15.9% of listed firms complied with the requirement to upload their audit committee charter to their websites. This low level of compliance should encourage an increase in OJK enforcement.

According to Regulation No. IX.1.5 released in 2004, public firms are required to have an audit committee and an audit committee charter. Considering that this regulation has active in force for almost 10 years, all public firms should have met this requirement. The results in Table 5, however, show that only 35.4% of firms in 2012 and 42.7% of firms in 2013 had

an audit committee charter and only about one third of them (15.9%/42.7%) uploaded their charter to websites. The whistleblower system is another item that has a very low level of disclosure as it involves significant cost and complex arrangements. Therefore, it is expected that only a small number of firms can afford it.

One of the items that has the highest increase in the level of disclosure is a

brief description of the audit committee's activities in the current year, as outlined in the audit committee charter. In 2012, the level of compliance is only 29.3%, which increased to 53% in 2013. This item is mandatory in the revised regulation. The results show that for certain items, mandatory requirements may increase the level of disclosure.

Table 6
Internal audit disclosure

No	Disclosure Items	Requirement starts in	Disclosure Level	
			2012	2013
1	Internal audit charter	2006	50%	50.8%
2	Internal audit charter items:			
a	Structure of internal audit unit	2012	26%	29.8%
b	Duties and responsibilities of internal audit unit	2012	36%	38.5%
c	Authorities of internal audit unit	2012	29%	30.5%
d	Internal audit unit's code of ethics that refers to code of ethics issued by Internal Audit Association in Indonesia or code of ethics that are commonly used internationally	2012	14%	18.6%
e	Requirements for auditors assigned to internal audit unit	2012	12%	13.5%
f	Responsibilities of internal audit unit	2012	22%	19.6%
g	Policy that prohibits internal auditor from having duties, positions, and activities in the company's operations, both in the parent and subsidiary companies	2012	10%	12.1%
3	Internal audit charter is signed by CEO upon approval of board of commissioners	2006	25%	27.5%
4	Internal audit head is assigned and dismissed by CEO upon approval of board of commissioners	2006	36%	42.9%
5	Internal audit head is responsible to CEO	2006	56%	58.5%
6	Disclosure on internal audit unit covers:			
a	Name	2012	55%	61.8%
b	Professional background	2012	44%	44.4%
c	Working experience	2012	43%	46.6%
d	Assignment base	2012	19%	22.6%
e	Qualification or certification as professional internal auditor (if any)	2012	14%	18.9%
f	Structure and position of internal audit unit	2012	31%	38.0%

Table 6 (continue)

g	Duties and responsibilities of internal audit unit as outlined in the internal audit charter	2012	33%	46.2%
h	Brief description of internal audit activities in the current year	2012	40%	42.2%
i	Description of the company's internal control system and internal control audit	2006	23%	34.4%
7	Description of the company's internal control system consists of at least:			
a	Financial and operational control, as well as compliance with laws and regulations	2006	40%	38.5%
b	Review of internal control system effectiveness	2012	26%	27.5%
Mean			39.5%	43.9%

In general, the level of disclosure of each component of audit committee and internal audit disclosure shows a relative increase (see Table 5 and Table 6). Audit committee disclosure shows an increase of 5.3%, from 45.2% in 2012 to 50.5% in 2013, whereas internal audit disclosure shows an increase of 3.7%, from 31% to 34.7% in 2012 and 2013 respectively. The increase, however, is still small. It was initially expected that following the introduction of the 2012 regulations, the level of compliance would increase significantly in 2013.

The level of internal audit disclosure as presented in Table 6 is also relatively low for all disclosure items (lower than 57%). The highest disclosure levels are for: internal audit charter (50%); internal auditor name (56%); and the reporting line of the internal audit to the CEO (55%). This relatively low disclosure level might be caused by internal audit regulations that do not require much information regarding internal audit activity. It was expected that the level of internal audit disclosure would increase

after the release of the revised regulations in 2012, which contained more detailed requirements.

Details of internal audit disclosure items in 2012 and 2013, as presented in Table 6, indicate that the level of disclosure is not high for all items, which are below 62%. The highest disclosures are for the: internal audit charter (50% in 2012 and 50.8% in 2013); name of the internal auditor (55% in 2012 and 61.8% in 2013); and the internal audit head who is responsible to the CEO (56% in 2012 and 58.5% in 2013). This evidence is quite similar to evidence arising from overall disclosure and audit committee disclosure. The item with the highest increase is duties and responsibilities of the internal audit unit as outlined in the internal audit charter, which was 33% in 2012, and increased to 46.2% in 2013.

CONCLUSION

This study had analysed the corporate governance (CG) practices of public firms in Indonesia, particularly audit committee

and internal audit practices, and how these practices meet the prevailing regulations of the Indonesian Capital Market Authority (OJK). Analysis was conducted based on secondary data obtained from annual reports, to measure the current practices of audit committees and internal audits.

Based on the content analysis of annual reports, we found that the level of CG disclosure (particularly disclosure related to audit committees and internal audits) in 2012 and 2013 was relatively low: only 39.5% in 2012 and 43.9% in 2013. The previous version of regulations lacked detailed requirements, resulting in the level of disclosure varying greatly across firms. In 2012, the OJK published revised versions of these regulations, which contained more detailed requirements. Thus, it was expected the 2013 annual reports would contain more detailed and higher levels of disclosure on firms' CG practice. However, results showed that the increase in the level of disclosure in 2013 was only 4.4% indicating that the detailed requirements in the revised regulations did not automatically increase the disclosure level. This was perhaps due to the new regulations and their concurrent enforcement not yet being in place.

Based on the analysis and findings, this study offers several recommendations. This study found the level of CG disclosure is relatively low, including disclosure of certain mandatory items and thus, regulators need to enforce their regulations in order to ensure full disclosure of CG practice by Indonesian listed firms. They need to fully comply with the regulations set by the

OJK, particularly the mandatory disclosure requirements. The annual report is one of the main information sources for investors when making investment decisions. Therefore, it should contain full disclosure of CG practices.

This study has several limitations. Only CG disclosure in annual reports was examined and not disclosures made by companies through other mediums, such as through website. In order to get a more comprehensive picture, in-depth interviews should be conducted to gather additional information on why firms disclose or do not disclose certain items. This study also did not examine the impact of disclosures on investors, creditors, and other stakeholders.

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