# Role of Audit Regulation on The Effect of Corporate Governanceand Audit Quality on Earnings Management

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**Abstract:** The Government of Indonesia through the Ministry of Finance shall regulate the audit services with the issuance of Decree of the Minister of Finance No. 423 / KMK.06 / 2002 on Public Accounting Services, which was subsequently revised by KMK No. 359 / KMK.06 / 2003 with the aim to realize a professional public accountant and independent public accounting firm. Regulatory reforms were carried out in the wake of the globalization crisis in 2008 in the implementation of Law No.5 of 2011 and lastly, also issued Government Regulation No.20 of 2015.

Based on the audit department's data (2017) found when the enactment of Law No. 5 of 2011, the number of public accounting firms that received warning sanctions increased and over time decreased. This indicates an improvement through the audit regulation. In addition, through the enactment of Government Regulation No.20 of 2015, found the existence of a violating public accounting firm so that it is subject to freezing sanctions in June 2015 and sanction of revocation in December 2015.

The same impact also applies to public accountants where in the period of application of Regulation of the Minister of Finance No.17 of 2008 there is only one freezing sanction on Public Accountant. This is because there is no criminal sanction in the audit regulation. However, in the period of the implementation of Law No. 5 of 2011, there was an increase in the number of sanctions against public accountant, although still in an insignificant number. In the period of enactment of Government Regulation No.20 of 2015, there is an increase in the number of sanctions against public accountant compared to the previous regulation. And after the 2017 OJK regulation strengthens Government Regulation No.20 of 2015, the number of sanctions on public accountants increases significantly in the first semester of 2017. This indicates that the enactment of the latest audit regulation proved to improve the quality of audit through the early and broadly detection of audit service violations.

In agency theory, agency relationships can lead to a conflict of interest that is when the manager as an agent performs an opportunistic act of doing earnings management in order to achieve targets charged by the principal (Meisser et al, 2006). This can occur because of the information asymmetry between the principal and the agent in which the agent knows more information than the principal and vice versa. The conflicts of interest can be minimized by a mechanism capable of aligning the interests of shareholders as owners with management interests. This mechanism is known for corporate governance in running its business. It is expected that the corporate control mechanism is effective through the monitoring role by the board of commissioners and audit committee (Dechow et al, 1995). The role of corporate governance as an internal factor of the firm in limiting or reducing earnings management activities (Klein, 2002; Xie et al., 2003).

Beside that in the agency theory, an independent auditor is a third party capable of safeguarding the interests of principals and agents in managing corporate finances where independent auditors can perform monitoring functions of agency work using a means in the form of financial statements (Setiawan, 2006). An auditor tests that the figures for financial statements used in the contract have been calculated in accordance with applicable procedures, and the possibility of violations in the terms set out in the contract (Watts and Zimmerman, 1986). The audit of financial

statements by the public accounting firm has a monitoring role in testing the credibility of accounting information generated by the agent so as to provide a fundamental role in ensuring reliable financial reporting with reduced agency costs (Jensen and Meckling, 1976;Imhoff, 2003).

This study was to examine the role of audit regulation on the effect of corporate governance and audit quality on earnings management. This study examined using structural equation modeling method with the approach of partial least squares (SEM-PLS). And also analyze differences test by using One Way ANOVA where is use to examine the differences audit regulation period on the effect of audit quality on earnings management such before and after implementation of Act No.5, 2011 and Government Regulation No 20, 2015. The research sample is purposive with a total of 79 manufacture companies listed on the Indonesia Stock Exchange in period 2008-2015 with 480 observation years.

The results showed a significant and negative relationship between independent commissioner and earnings management, while audit committee and earnings management shows no significant. Audit quality influences negatively and significantly on earnings management. Beside it, One Way ANOVA test shows that audit quality influences negatively and significantly on earning management especially in implementation of audit regulation during period 2008-2010 and period 2011-2014. Overall, research conclude that the changes of audit quality is significantly effect on earnings management mitigation in companies.

**Keywords:** audit regulation, audit quality, corporate governance, earnings management

## Introduction

The Government of Indonesia through the Ministry of Finance regulates the audit services with the issuance of Decree of the Minister of Finance No. 423 / KMK.06 / 2002 on Public Accounting Services, which was subsequently revised by KMK No. 359 / KMK.06 / 2003 with the aim to realize a professional public accountant and independent public accounting firm. Regulatory reforms were carried out in the wake of the globalization crisis in 2008 in the implementation of Act No.5 of 2011 and lastly, also issued Government Regulation No.20 of 2015.

Based on data from Finance Profession Supervisory Center (Pusat Pembinaan Profesi Keuangan- PPPK), Ministry of Finance (2017) on the implementation of Act No. 5 of 2011, we found that the number of public accounting firms which received warning sanctions increased and over time decreased. This indicates an improvement of audit quality through the audit regulation. In addition, through the enactment of Government Regulation No.20 of 2015, we found the existence of a violating public accounting firm so that it is subject to freezing sanctions in June 2015 and sanction of revocation in December 2015.

The same impact also applies to public accountants where in the period of application of Regulation of the Minister of Finance No.17 of 2008 there is only one freezing sanction on Public Accountant. This is because there is no criminal sanction in the audit regulation. However, in the period of the implementation of Act No. 5 of 2011, there was an increase in the number of sanctions against public accountant, although still in an insignificant number. In the period of enactment of Government Regulation No.20 of 2015, there is an increase in the number of sanctions against public accountant compared to the previous regulation. And after the 2017, the Regulation of Securities and Exchange Commission (known as Otoritas Jasa Keuangan -OJK) No.13 of 2017 has strengthen Government Regulation No.20 of 2015, the number of sanctions on public accountants increases significantly in the first semester of 2017. This indicates that the enactment of the latest audit regulation proved to improve the quality of audit through the early and broadly detection of audit service violations.

In agency theory, agency relationships can lead to a conflict of interest that is when the manager as an agent performs an opportunistic act of doing earnings management in order to achieve targets charged by the principal (Meisser et al, 2006). This can occur because of the information asymmetry between the principal and the agent in which the agent knows more information than the principal and vice versa. The conflicts of interest can be minimized by a mechanism capable of aligning the interests of shareholders as owners with management interests. This mechanism is known for corporate governance in running its business. It is expected that the corporate control mechanism is effective through the monitoring role by the board of commissioners and audit committee (Dechow et al, 1995). The role of corporate governance as an internal factor of the firm in limiting or reducing earnings management activities (Klein, 2002; Xie et al., 2003).

Beside that in the agency theory, an independent auditor is a third party capable of safeguarding the interests of principals and agents in managing corporate finances where independent auditors can perform monitoring functions of agency work using a means in the form of financial statements (Setiawan, 2006). An auditor tests that the figures for financial statements used in the contract have been calculated in accordance with applicable procedures, and the possibility of violations in the terms set out in the contract (Watts and Zimmerman, 1986). The audit of financial statements by the public accounting firm has a monitoring role in testing the credibility of accounting information generated by the agent so as to provide a fundamental role in ensuring reliable financial reporting with reduced agency costs (Jensen and Meckling, 1976;Imhoff, 2003).

**Literature Review**

Jensen and Meckling (1976) describe agency relationships within agency theory that a company or entity is a contractual nexus of the contract between the owner of the economic resource (principal), the owner or shareholder of an open company, and the manager (agent). Each individual in the contract has an incentive to maximize their respective interests thereby generating agency costs that can reduce the value of the company (Watts and Zimmerman, 1986). The problem of agency relationships led to the occurrence of information asymmetry and the conflict of interest due to the inequalities of goals (Meisser, et al., 2006) that triggered earnings managements activities from management (as an agent). Opportunistic earnings management is one of the forms of agency costs. This is because managers try to hide company performance from parties outside the entity so it's easy to control the private benefit (Leuz et al., 2003). In order to overcome or reduce earnings management activities, the principals require an independent third party as a mediator between the principal and the agent, through the corporate governance mechanism and the quality of audits performed by the independent auditor.

**Relationship between Corporate Governance and Earnings Management**

According to agency theory, earnings management activities can be limited by a quality of good corporate governance that can align the interests of various parties. Corporate governance is a mechanism that can be used by shareholders and corporate lenders to control the earnings management activities undertaken by management. The good quality of corporate governance is expected to be a barrier to earnings management activities so as to improve the quality of financial statements. In this study, the proxies used for corporate governance are the quality of the board of commissioners and audit committee.

Xie et al (2003) examines corporate governance and management behavior in listed companies in the US stock exchange with emphasis on corporate governance mechanisms on the number of meetings held by board of directors, executive committees and audit committees to prevent earnings management behavior. However, Carcello and Neal (2000) conclude that the earnings management behavior can be reduced if the competence and independence of the audit committee are maintained. Fama and Jensen (1983) state that non-executive directors can act as intermediaries in disputes that occur between internal managers and oversee management policies and provide advice to management. Proven in Nasution and Setiawan (2007) research concludes the composition of board of commissioners affecting earnings management activities negatively.

H1a; Boards of commissioner negatively influences Earnings Management

H1b; Audit Committee negatively influences Earnings Management

**Relationship between Audit Quality and Earnings Management**

De Angelo (1981) defines audit quality as a probability where an auditor finds and reports a violation in the client's accounting system. In the Public Accountant Professional Standard (2011) states that public accountants are in a responsible manner to be aware of the characteristics and types of potential material irrelevant, in relation to the audited areas, so that public accountants can plan their audit to provide reasonable assurance in detecting Irregularity of the material. Qualified auditing process will be able to provide adequate protection and confidence that financial statements are free of material misstatement, whether caused by mistakes or fraud.

Audit quality can also be a predictor that can reduce earnings management actions (Chen et al, 2005; Chiang et al, 2011; Sharma et al, 2011). Firth and Liau Tan (1998) say that the quality of the audit is often associated with the size of the public accountant's office which is considered to be of superiority in four dimensions, namely: (1) the large number and variety of clients handled by the public accountant office; (2) the variety of services offered; (3) extent of geographical coverage, including international affiliation; And (4) the number of audit staff in a public accounting firm. Knechel et al (2007) finds that there is an indication of the lack of auditor independence in conducting audits, because of the length of work engagement with the client and its findings indicate the weak

influence of the auditor's turnover on the increase or decrease in audit quality. Stein and Cadman (2005) find that auditors specializing in client industry will provide high quality auditing.

Previous research results have documented that a high audit quality was able to reduce corporate earnings management (Jordan, Clark & Hames, 2010; Yasar, 2013). The results of the study conclude that auditors are able to detect client-based accrual-based profits so that the auditors make restrictions on aggressive accrual accounting (Chen et al., 2005; Chiang et al, 2011; Sharma et al, 2011).
H2; Audit Quality negatively influences Earnings Management

**The Role of Audit Regulation on Earnings Management before and after Indonesia Act No 5 of 2011 and Indonesian Government Regulation No 20 of 2015.**

In order to improve the quality of the audit, the government issued several regulations governing the oversight of the quality of audit services performed by the public accounting firm through Decree of the Minister of Finance No. 423 / KMK.06 / 2002 in 2002, then revised by Minister of Finance Decree No. 359 / KMK.06 / 2003 year 2003.
During the global crisis in 2008, the government revised its regulatory regulation with Regulation of the Minister of Finance No. PMK No.17 / PMK.01 / 2008. In the audit regulation revision, article 3 is emphasized on the restriction of the provision of audit services whereby the public accounting firm is limited to a maximum of six years and the public accountant is limited to a maximum of three years. Restrictions on audit periods are expected to enhance the independence of auditors and public accountants so audit quality is better and lack of dependency and long-term engagement with audit clients.

However, over time, there has been a significant case in Indonesia Capital Market which is a case involving several public go public such as PT Bakrie & Brothers Tbk (BNBR), PT Bakrie Sumatra Plantations Tbk (UNSP), PT Energi Mega Persada Tbk (ENRG), and PT Benakat Petroleum Energy Tbk (BIPI). In this case it was found that the manipulation of the interim financial statements was a violation of accounting on deposit revenue of Bank Capital Indonesia (REA). This accounting violation should be identified by Public Accounting Firm when auditing because there is only one Public Accountant Office auditing BNBR, UNSP and ENRG. Through Securities and Exchange Commission (SEC), the Government issued SEC Decree No. Kep-86 / BL / 2011 dated on 28 February 2011. Enacted by Act No. 5 of 2011 effective from May 3, 2011 where the Act has a heavier law enforcement element than the previous regulations because the Law regulates the existence of Penal Code for Public Accountants and Corporations in article 55 where in the event of financial manipulation it shall be punished with imprisonment for a maximum of five years and fined of not more than 300 million Indonesian Rupiah.

The Act No. 5 of 2011, however, did not provide a clear limitation on the details and the timing of providing audit services by a public accountant. Practically, it was found that the adoption of Act No. 5 of 2011 on the timing of public accountant auditing can only be implemented well in the Sole Proprietorship Public Accountants Firm. However, within the Partnership Public Accountant Firm or Public Accounting Firm that has more than one Partner, the implementation of Act No. 5 of 2011 still has a loophole in the limiting period of public accountant assignment, which was found a public accountant who wanted to extend the term of the audit assignment, it was conducted by adding another public accountant at a particular Public Accountant Firm, such as, the AB Public Accountant Firm became ABC Public Accountant Firm and then when the assignment of a public accountant will be exhausted again, it will again be done by adding a public accountant from the ABC Public Accountants Firm became ABCD Public Accountant Firm. This condition can threaten the level of independence of public accountants. With such a phenomenon, the Government immediately imposes Government Regulation No.20 of 2015, which in Articles 10 and 11 does not limit the term of audit service assignment to the Public Accountant Firm, but rather focuses on the limitation of the appointment of auditors by the Public Accountant only for a maximum of 5 (five) years and may return the audit service within 2 (two) years later. Through the implementation of this regulation, the level of independence of public accountants as assessors on audit reports is better and accountable to the public. It is also perceived as important and urgent by the Financial Services Authority, so SEC through Regulation POJK No.13 / POJK.03 / 2017 also includes the limitation of the appointment of a Public Accountant audit service at maximum three years and may re-provide its audit services after two years conduct non audit service (cooling-off period).

Some previous studies have found regulatory associations with earnings management forms. Cohen et al. (2008) and Cohen and Zarowin (2010), for example, found that after the release of regulations through the SOX Act in America, the behavior of earnings management accrual and the tendency to meet the profit target decreased, but the behavioral management profit management behavior actually increased compared to the previous period. Zhou (2008) also found evidence that after the enactment of regulations in audit services and public companies in America, the company not only became more conservative, but also reported lower absolute discretionary accruals.

Cohen et al. (2008) and Cohen and Zarowin (2010) found a shift in the pattern of earnings management behavior from accruals to real transactions after the SOX Act issued.
Based on the above empirical evidence of the study, it can be concluded that the implementation of different audit regulations may affect the relationship between audit quality and earnings management.

H3a; Audit Regulations have a role in the effect of audit quality that negatively impact earnings managements before Act No.5, 2011 (for a period 2008 to 2010)
H3b; Audit Regulations have a role in the effect of audit quality that negatively impact earnings managements in period of implementation Act No.5, 2011 (for a period 2011 to 2014)
H3c; Audit Regulations have a role in the effect of audit quality that negatively impact earnings managements in period of implementation Government Regulation No 20 of 2015. (for period 2015)

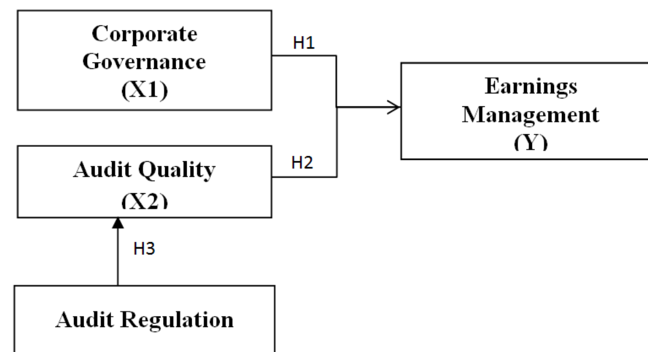


Figure 1
Conceptual Framework

**Method**

The populations are companies in the manufacture sector, which has been listed on the Indonesia Stock Exchange (BEI). The units of analysis used in this study were organizations, namely the go public company that are selected based on purposive sampling method. Samples were selected based on suitability to the characteristics of the sample criteria specified such as companies listed in Indonesia Stock Exchange in 2007 and the company never delisting in stock exchange. Total samples are about 69 listed companies with 480 observation years in period 2008-2015.

Earnings Management was measured using performance matched discretionary accrual model based on Kothari et al (2005); Corporate Governance was evaluated using Corporate Governance Check List based on Hermawan (2011) which consists 17 indicators of Boards of commissioner and 11 indicators of Audit Committee (*see appendix 1*); and Audit Quality was measured Audit Quality Metrics Score(AQMS) based on Herusetya (2012). AQMS consists of public accountant firm size; industrial specialty; tenure of the public accountant firm audit assignment; and the willingness and accuracy in reporting audit opinion going concern. The value of AQMS scores is increasingly reflecting the higher audit quality.

Model analysis of the data testing was performed by structural equation modeling with approach partial least squares (SEM-PLS) that supported by SmartPLS 3.0 as statistic tool.And also analyze differences test by using One Way ANOVA where is use to examine the differences audit regulation period on the effect of audit quality on earnings management such before and after implementation of Act No.5, 2011 and Government Regulation No 20 of 2015 that supported by SPSS 22.0 as a statistic tool.

**Results**

This study used 480 observation years of manufacture companies listed in Indonesian Stock Exchange (IDX). In descriptive statistics, it shows that audit committee and boards of commissioner are the highest mean between all variables (see table 1).

**Table 1: Descriptive Statistics**

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Boards of commissioner | 480 | 0.94 | 2.53 | 1.77 | 0.28939 |
| Audit Committee | 480 | 1.00 | 3.00 | 2.16 | 0.55867 |
| Audit Quality | 480 | 0.00 | 1 | 0.34 | 0.29900 |
| Earnings Management | 480 | -0.62 | 0.42 | -0.0681 | 0.15302 |
| Valid N (listwise) | 480 | | | | |

***Empirical Tests***

In SEM-PLS, there are some tests such as outer model, inner model and hypothesis tests. On outer-modeltest, variables consider valid if t-statistics of its indicators are more than 1.96 (Chin, 1998; Hair et al, 2011). It means that indicators can reflect on a variable.

Evaluation of outer model test concludes that 17 indicators of the Board of Commissioners indicate significance with t-statistic above 1.96. This means that all indicators used to reflect the variable of board of commissioners are valid. Among the 17 indicators, the NC indicator (Nominating Committee) is stronger reflecting the board of commissioners with a t-statistic value of 4.947. For Audit Committee, there is only one significant indicator of 11 indicators. That was EKL (Complete Committee Evaluation) with a t-statistic value of 2,320 (t-stats> 1.96). This means that only audit committee evaluation indicators can reflect audit committees. Lastly, for Audit Quality and Earnings Management variables are not obtained t-statistics results because it only uses 1 indicator which can't be processed by statistical tool SmartPLS 3.0.

In inner model, it tests how well the observation value is generated by the model and also estimates its parameters. The result shows that Earnings Management variable has influence with the predictive strength of the overall model of 0.328 or 32.8%, while 67.2% is influenced by other factors or variables that are not included in the equation model.

One-tailed hypothesis test is done by looking at the value of t at 95% confidence level (significance level of 0.5%) and the path coefficient (β) on each of the hypothesized relationship between the variables. Based on the rule of thumb, hypothesis is tested significantly if t-value is more than 1.64 (Hair et al, 2008).

Below is a table of test results of the calculation output relationship between variables that are used to test the hypothesis:

**Table Hypothesis Tests**

| Hypothesis | Estimation | t-value | Test Results |
|---|---|---|---|
| H1a : boards of commissioner→earnings management | -0.318671 | 3.836800 | Significant |
| H1b: audit committee →earnings management | -0.001378 | 0.009998 | No significant |
| H2 :audit quality→ earnings management | -0.220101 | 2.436574 | Significant |
| H3a :audit quality→ earnings management (period 2008-2010) | -0.230421 | 1.986572 | Significant |
| H3b :audit quality→ earnings management (period 2011-2014) | -0.310104 | 1.993521 | Significant |
| H3c :audit quality→ earnings management (period 2015) | -0.002163 | 1.435534 | No significant |

**one tailed, α = 5%*

The results showed a significant and negative relationship between boards of commissioner and earnings management, while audit committee isn't significant. Then, this result also showed that a significant and negative influences of audit quality to earnings management overall. Besides that, this result also showed that a significant and negative influences of audit quality to earnings management during period 2008-2015 (before Act No 5 of 2011)

and 2011-2014 (during the enactment of Act No 5 of 2015). For period 2015 where Government Regulation No 20 of 2015 was implemented, the result show that audit quality can't influence significantly on earnings management.

***Differentiation Test***

This study conducted a different test on the operational variables using secondary data where the differences in the research samples before the enactment of Act No. 5, 2011 (period 2008-2010), during period the Act No. 5, 2011 (period 2011-2014) and during Government Regulation No.5, 2015. Differentiation test in this study using analysis of variance or ANOVA is one of the multivariate analysis techniques that serves to differentiate more than two data groups by comparing the variance (Ghozali, 2013).

**Table 3: Group Statistics**

| | N | Mean | Std. Deviation | Std. Error | 95% Confidence Interval for Mean | | Minimum | Maximum |
|---|---|---|---|---|---|---|---|---|
| | | | | | Lower Bound | Upper Bound | | |
| 1 | 187 | .3757 | .28911 | .02114 | .3340 | .4174 | .00 | .75 |
| 2 | 234 | .3184 | .29412 | .01923 | .2805 | .3563 | .00 | .75 |
| 3 | 59 | .2712 | .24691 | .03215 | .2068 | .3355 | .00 | .75 |
| Total | 480 | .3349 | .28844 | .01317 | .3090 | .3608 | .00 | .75 |

**1=Period 2008-2010; 2=Period 2011-2014; 3=Period 2015*

Based on the table above, the average number of audit quality in audit regulation 1(period 2008-2010). is 0.3757; (2) the average audit regulation 2 (period 2011-2014). = 0.3184 and (3) the average audit regulation 3 (period 2015). = 0.2712 and it can be concluded that the highest average number of audit quality in audit regulation 1(period 2008-2010).

**Table 4: One Way ANOVA (F Test)**

| | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|
| Between Groups | .614 | 2 | .307 | 3.733 | .025 |
| Within Groups | 39.239 | 477 | .082 | | |
| Total | 39.853 | 479 | | | |

**1=Period 2008-2010; 2=Period 2011-2014; 3=Period 2015*

Based on the table above, the p-value of 0.025 is smaller than 0.05 so it can be said Ha is accepted, which states that from the three audit regulatory groups there is a real difference. And differences in the number of Audit Quality are in audit regulation 1(period 2008-2010).

**Conclusions**

This study analyzes the influence of corporate governance, audit quality and earnings management on corporate value. In addition, this study examined the differences in audit regulation on the effect of audit quality on corporate value. The test results conclude that boards of commissioners as a proxy of corporate governance positively affects earnings management. Audit quality has a negative effect on earnings management, especially in the period 2008-2014.

Audit quality has a negative and significant effect on earnings management in the period 2008-2010 and the period 2011-2014. But apparently among the three periods, the 2008-2010 period of regulatory audits had averages higher than other periods. In addition, the most noticeable difference occurred between the 2008-2010 period's audit regulation and the 2011-2014 period's audit regulation. On the other hand, the significant difference between period 2011-2014 and period 2015 in conjunction with the enactment of Government Regulation No.20, 2015 aren't too large, so the enhanced audit quality is not significant. It was concluded that the adoption of new regulations improved the quality of audits and improved audit quality that was most significant in the period 2008-2010 and the period 2011-2014.

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## APPENDIX I
## Corporate Governance Checklists

| No | Description | Good | Fair | Poor |
|---|---|---|---|---|
| Part 1 – Board of Commissioners Score | | | | |
| | A. Board Independence | | | |
| 1 | Among board of commissioners. how many are independent commissioners?<br><br>If more than 50% ofthe board is independent, the company will be given a 'good' score. Firms with 30% to 50% of the board made up of independent commissioners will earn a 'fair'score. Ifless than 30% of the board is independent, or no information, the company will earn a 'poor'score. | | | |
| 2 | Is the chairman an independent commissioner?<br><br>If the chairman is an independent commissioner, the firm will earn a 'good' score and 'poor' score otherwise or if no information. | | | |
| 3 | Docs the company state in its annual report the definition of independence?<br><br>Firms with a clear definition of independence in the annual | | | |

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| | report will earn a 'good' score. A 'poor' score will be given if the company does not define independence or if no information. | | | |
| 4 | Among board of commissioners, how many 3fe employees of shareholders or affiliated companies owned by shareholders?<br><br>If there is more than 50% of the board, or 110 information, the company will be given a 'poor' score. If there is 30% to 50% of the board, the firm will earn a 'fair' score. If less than 30% of the board, the company will earn a 'good' score. | | | |
| 5 | Does the company have a nominating committee and remuneration committee?<br><br>Firms that have both committees will earn a 'good' score. Firms that have at least one of the two committees will earn a 'fair' score. A 'poor' score will be given to the company that does not have any ofthese committees or ifno information. | | | |
| 6 | What is the average years the Board of Commissioners' tenure?<br><br>If the average tenure of the board is less than 5 years, the company will receive a 'good'score. Ifthe average tenure of board is between 5 and 10 years, the score is 'fair', and ifthe average tenure is more than 10 years, the score will be 'poor'. | | | |
| | B. Board Activities | | | |
| 7 | Does the company clearly describe 'the board responsibilities?<br><br>If board responsibilities are clearly stated and disclosed, the firm will receive a 'good' score. Company that has not defined board responsibilities or no information will earn a 'poor' score. | | | |
| 8 | How many meetings were held during the year?<br><br>If the board meets more than six times, the firm earns a 'good' score. If 4 -6 meeting, the firm is scored as 'fair', while less than four times or no information is scored as 'poor'. | | | |
| 9 | What is attendance performance of the board members during the year?<br><br>Ifthe overall board attendance for the year is greater than 80%. the firm earns a 'good' score. Ifattendance is 70-80% receives a 'fair'' score, and less than 70% or no information receives a 'poor' score. | | | |
| 10 | Does the company have a separate board of commissioner's report describing their responsibilities in reviewing firm's financial statement? | | | |

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| | Firms will receive a 'good' score if they produce a board of commissioner's report as part of the annual report. A score of 'poor'will be awarded if there is no report from the board or no information. | | | |
| 11 | Does the BOC conduct annual assessment of the BOD?<br><br>If the board evaluates the performance ofthe top executive officer, the company received a 'good' score and 'poor' score otherwise or no information. | | | |
| 12 | Does the board conduct assessment of the business prospects prepared by the BOD?<br><br>If the board assess the business prospects, the company received a 'good' score and 'poor' score otherwise or no information | | | |
| | C. Board Size | | | |
| 13 | What is the size of the board of commissioner?<br><br>A 'good' score will be given to firm with 5 -10 board members. Firm with board size of 11 -15 members received a 'fair' score. Boards with size of 16 or more or less than 5 members, or no information will receive a 'poor' score | | | |
| | D. Board Expertise and Competence | | | |
| 14 | Does the board member have a sophisticated knowledge about accounting and finance?<br><br>If there is more than 50% of the board has the knowledge, the company will be given a 'good' score. ifthere is 30% to 50% of the board, the firm will earn a 'fair' score. if less than 30% of the board, or no information, the company. will earn a 'poor' score. | | | |
| 15 | Does the board member have sufficient experience about business (i.e. has the experience as a member of the board of commissioners in any company including this company or as a CEO in other company)?<br><br>If there is more than 50% of the board has the experience, the company will be given a 'good'score. If there is 30% to 50% of the board, the firm will earn a 'fair' score. If less than 30% of the board, or no information, the company will earn a 'poor' score. | | | |
| 16 | Does the board member have a sophisticated knowledge about~ the company' s bu~il1ess?<br><br>If thereis more than 50% of the board member has the knowledge, the company will be given a 'good' score. If there is | | | |

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| | 30% to 50% of the independent board member, the firm will earn a 'fair' score. If less than 30% of the independent board member, or no information, the company will earn a 'poor' score. | | | |
| 17 | What is the average age of the board?<br><br>Ifthe average age of the board is more than 40 years old, the company will receive a 'good' score. If the average age of the board is between 30 and 40 years old, the score is 'fair', and if, the average age is below 30 years old, the score will be 'poor', | | | |
| Part 2 – Audit Committee Score | | | | |
| | A. Audit Committee Activities | | | |
| 1-5 | Assess the responsibilities fulfilled by the audit committee during the year, include the following items:<br><br>1. Evaluating internal control<br>2. Propose auditor<br>3. Financial report review<br>4. Evaluating legal compliance<br>5. Prepare a complete audit committee report for disclosure.<br>In each category, ifthe responsibility is fulfilled, firms will receive a 'good' score. If the responsibility is not fulfilled, or no information, the company will receive a 'poor' score. | | | |
| 6 | How many meetings were held during the year?<br><br>If the audit committee meets more than six times, the firm will earn a 'good' score. If 4 -6 meeting, the firm will earn a 'fair' score, while less than four lime or no information will be scored as 'poor''. | | | |
| 7 | What is attendance performance of the audit committee members during the year?<br><br>If the overall audit committee attendance for the year is greater than 80%, the firm earns a 'good' score. If attendance is 70 -80% receives a 'fair' score, and less than 70% or no information receives a 'poor' score. | | | |
| 8 | Does the audit evaluate the scope, accuracy, cost effectiveness, independency and objectivity of external auditor'!<br><br>If the audit committee evaluates all of the items, the firm has a 'good' score, If only some part of the items was evaluated, the score will be 'fair', And ifnone of the items was evaluated, the score will be 'poor', | | | |

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| | B. Audit Committee Size | | | |
| 9 | What is the size of the audit committee?<br><br>If there are 3 people in the audit committee the score will be 'fair', and if there is more than 3 persons in the audit committee, the score will be 'good', If there is no information, the score will be 'poor', | | | |
| | C. Audit Committee Expertise and Competence | | | |
| 10 | Does the audit committee have an accounting background'!<br><br>If the company has more than 1 person with accounting background. the firm will earn a 'good' score. If the company has only 1 person with accounting background, the firm earns a 'fair" score, and if none has accounting background or no information, the score will be 'poor',. | | | |
| 11 | What is the average age of the audit committee?<br><br>If the average age of the audit committee is more than 40 years old, the company will receive a 'good' score. If the average age of the audit committee is between 30 and 40 years old, the score is 'fair', and if the average age is below 30 years old, the score will be'poor'. | | | |