

EVIDENCE ON AUDIT COMMITTEE COMPOSITION AND AUDIT COMMITTEE EFFECTIVENESS AMONG LISTED COMPANIES IN THE JAKARTA STOCK EXCHANGE

Siddharta Utama and F. Leonardo Z

Siddharta Utama is the chairman of Department of Accounting at FEUI, and F. Leonardo Z. is a alumnus of Magister Accounting (MAKSI) at FEUI

Abstract

The purpose of this study is to provide empirical on audit committee composition and audit committee effectiveness (ACE), based on a survey of audit committees of publicly listed companies in the Jakarta Stock Exchange. The study finds that the majority of the companies comply with the JSX requirement about the minimum number of audit committee member (3 persons), their independence, and their competence (finance or accounting background). However, this study finds that audit committees are not yet effective in their authority, resources, and efforts. The interaction of audit committee with external auditors is the least effective while the communication to the board of commissioners and shareholders is the most effective. The interaction of audit committee with internal auditors and monitoring on compliance are also ineffective.

Kata Kunci: Audit committee, effectiveness, composition.

INTRODUCTION

In 1998, Indonesia suffered the worst economic crisis in its history. The economy slumped more than 13% in one year and it took more than 5 years before its GNP reached its 1997 level. There were many causes for the crisis, one of them was the lack of good corporate governance practice in Indonesia.

Even until now, some surveys indicate that investors still perceive Indonesia as among the worst countries in term of its corporate governance (CG) practice. A survey conducted by Credit Lyonnais Securities Asset (CLSA) gave Indonesia a score of 2.9 (out of 10) for

its CG practice in 2002, down from 3.2 in 2001. This score was the lowest among countries in South East Asia region. McKinsey Investor Opinion Survey in July 2002 also placed Indonesia as among the worst countries in Asia in applying CG, this result was the same as that conducted in 2000.

As a response to this, regulators have set up some rules aiming at improving CG practice in Indonesia. In May 2000, Bapepam (Badan Pengawas Pasar Modal – Capital Market Supervisory Body) issued a statement recommending publicly listed companies to establish audit committee. In July 2001, the Jakarta Stock Exchange (JSX) made a stronger regulation: All companies listed in the JSX are required to have independent commissioners, audit committee, and corporate secretary. In addition to elaborating the tasks of these bodies, it also specifies the qualification to become independent commissioners and a member of audit committee. Finally in March 2004, Bapepam followed JSX in obliging all public companies to have audit committees.

Note that the regulations place an important role of audit committee (AC) to enhance the CG practice as it is the only committee required to be established by the companies. Other committees, such as risk management, nomination, and remuneration committees are not compulsory. Despite this requirement, however, not all companies followed the rule. As of June 2003, two years after the rule was issued, only 85% of companies in the JSX have AC. This fact may indicate the low awareness among public companies on the importance of GCG. Further, since the establishment of AC is due to external pressure (mandatory by JSX and Bapepam) and not due to the awareness of the companies themselves, it is possible that the establishment of audit committee is just to fulfill the obligation and thus, it may not perform the role that it supposes to be. Therefore it is interesting to empirically examine whether firms comply with regulation on the composition of AC and how effective AC in performing its duties.

Based on the above explanation, the objectives of this study are:

- To provide evidence on AC composition in Indonesia in term of its independence and expertise.
- To provide evidence on ACE in Indonesia.

This study extends current literature by providing evidence on audit committee composition and its effectiveness among listed companies in the JSX. We find that the majority of the companies have AC that are independent and financially literate. However, audit committees in our sample are not yet effective.

The remainder of this paper is organized as follows. The second section provides a review on the role of AC, the composition of AC and audit committee effectiveness. The third section describes research design. Section four explains the results while the final section provides conclusion.

LITERATURE REVIEW

The Role of Audit Committee

Audit committee plays an important role in supporting good corporate governance practice. According to OECD (2000), five principles of good corporate governance are: 1. Protecting shareholders' rights, 2. Equitable treatment of shareholders, 3. Recognizing the role of stakeholders, 4. Ensuring timely and accurate disclosure and transparency, 5. Ensuring effective monitoring by the board, and the board's accountability to the company and the shareholders. The application of the last two principles highly depends on the effectiveness of audit committee.

Accurate presentation of financial performance and sound internal controls are the essence of protection and assurance to shareholders. The major role of the board of commissioner is to oversee these aspects of financial controls, and to do that, it delegates to AC. Thus, the primary responsibility of AC is to oversee, on behalf of the board, the integrity of financial reporting controls and procedures implemented by management.

To fulfill its responsibility, AC has to work together with internal as well as external parties that are involved in the financial reporting supply chain. Consistent with other literature on the tasks of AC, according to Institute of Corporate Directors (2003), the tasks of AC include:

- A. Ensure that the external auditor of the firm is independent and competent. In this respect, it makes recommendations to the board for the appointment of the auditor, determining the audit fees, review the scope of work, and hold private meetings with the auditors to discuss their findings.
- B. Evaluating the performance of internal audit division, including reviewing the hiring decisions concerning key internal audit positions, reviewing the scope and results of internal audit activities, and evaluating the independence and objectivity of the internal audit function;
- C. Reviewing management reports, interim statements, annual financial statements, and other disclosure statements to regulatory authorities and the public, ensuring that such reports are accurate, fair, and prepared according to generally accepted accounting and auditing standards;
- D. Overseeing the installation and operation of an adequate internal control system that provides reliable reports, safeguarding of assets, and compliance with rules and regulation. In carrying its tasks, AC has to maintain a productive, open, and professional relationship with the board, the CEO, CFO, and other relevant parties.

Composition of Audit Committee

To be effective in performing its tasks, the Treadway Commission (1987) suggests that audit committee has to have the ability to act independently and question management/ other relevant parties. Therefore, the commission, as well as the Cadbury Committee (1992),

the Public Oversight Board (1993) and the Blue Ribbon Committee (1999), suggest that AC consist solely of outside, non-employee directors. It is expected that AC consisting solely of outside directors would be more likely to undertake activities and procedures which improve financial reporting system and corporate governance.

Since primary responsibility of AC is to ensure the integrity of financial reporting system, then the some members of AC have to have expertise in the areas of accounting and financial reporting, internal controls, and auditing (Kirk Panel 1994). The SEC (1999) also beliefs that having at least one member with an accounting or finance background will improve ACE.

This qualification of the audit committee is followed by the JSX in its ruling. The rule requires that audit committees consist of at least three members, one of them is the independent commissioner who chairs the committee. All members should be external-independent parties, who at least one of them has competency in accounting or finance.

The Effectiveness of the Audit Committee

Empirical literature on ACE is diverse and expansive. DeZoort et al. (2002) provides a comprehensive literature review on empirical literature on ACE. They define an effective audit committee as a committee that *'has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts.'* This definition covers the input (qualification), process (authority, resources, and efforts), and output (reliable financial reporting, internal controls, and risk management) dimensions of ACE.

DeZoort et al (2002) further describes the meaning of the input and process. Qualification refers to audit committee composition in term of expertise, independence, integrity, and objectivity. Authority refers to the function of the audit committee's responsibilities and influence. The audit committee derives its authority from the board of directors (or the board of commissioners in Indonesia) and its degree of authority is explained in the audit committee charter. Resources include an adequate number of committee members, as well as access to management, external auditors, internal auditors, the board, and legal counsel. Finally, efforts/diligence refers to the willingness of committee members to work as needed.

Earlier studies on AC focus on the impact of the presence of audit committees on the quality of financial reporting. DeFond and Jiambalvo (1991) find that firms with audit committees are less likely to overstate annual earnings. However, the presence of AC will not be effective without accompanied by adequate qualification, authority, resources and efforts. Therefore, later studies on AC switch to focus on these aspects.

Regulation on Audit Committees for Publicly Listed Companies in Indonesia

On May 2000, Bapepam issued a statement (SE-03/PM/2000) that recommends public companies to form audit committees. The audit committee consists at least three members, consisting of one independent commissioner (as the chair of the committee) and two independent external parties. The member of the committee has to comprehend accounting, audit, and internal system in the firm.

One year later, the JSX issued a rule (Kep-339/BEJ/07-2001 and SE-008/BEJ/12-2001) that obliges companies listed in the JSX to have audit committees. The requirement of AC composition is the same as Bapepam, with at least one member has expertise in accounting and/or finance. External parties are those who are not commissioners, directors, and employees of the companies. Independent parties are those that (1) do not have business relation and affiliation with the listed companies, commissioners, directors, and majority shareholders; (2) are able to provide professional opinion freely in accordance to their professional ethics, and (3) do not have any special interest. The rule also specifies the tasks of AC to providing independent professional opinion to the board of commissioners and:

- Analyzing and reviewing financial information issued by the firm, such as financial statements, projections, and other information.
- Reviewing the independence and objectivity of public accountants.
- Analyzing and reviewing the adequacy of tests conducted by external auditors to ensure that all material risks have been considered.
- Analyzing and reviewing the effectiveness of the internal control of the firm.
- Reviewing the firm's compliance on regulation in the capital market and in other areas related to the firm.
- Investigating to the possibility of error/misconduct by the management.

In conducting its duties, AC has to submit its findings to all members of the board at most two days after the report completes. It also is obliged to submit report on its activities to the Board of Commissioners at least once in every three months.

Finally in March 2004, Bapepam followed JSX in obliging all public companies to have an audit committee. With this requirement, all companies listed in stock exchanges in Indonesia have to establish audit committees¹.

The substance of regulations by Bapepam and JSX is not different from that in developed countries, such as U.S. However, enforcing this regulation is another matter, considering different ownership structure in Indonesia from that in developed countries.

¹ Other than the JSX, Indonesia has another stock exchange: Surabaya Stock Exchange.

RESEARCH DESIGN

This study attempts to document ACE among listed companies in Indonesia. Effectiveness denotes the degree of agreement between the expected output and its realized output. As mentioned earlier, the expected output of AC is reliable financial report, internal control and risk management. However, many factors affect this output so it's difficult to attribute the resulting output due to AC. Further, in Indonesia, firms just established audit committees two or three years ago, so the impact on the expected output remains to be seen. Therefore, we measure ACE not in term of its output, but in term of its actual process (authority, resources, and efforts). We follow K. Raghunandan et al. (2001) by examining the impact of audit committee composition (input) to its process (interaction with internal audit), but we expand the process to also include other tasks of AC, as specified by the JSX rule. These tasks can be grouped into four components: (1) interaction with external auditors, (2) interaction with internal auditors, (3) access to financial reports and monitoring on compliance, (4) interaction with the board of commissioners and board of directors.

To collect data, as in other AC studies, we conduct a survey on listed companies in the JSX and develop a questionnaire that will document AC composition and its effectiveness.

Development of Questionnaire

The questionnaire is developed based on literature and rules/regulation about the composition and the task of audit committees, especially the regulation of the JSX. The questionnaire consists of three parts:

1. The first part consists of general information about the firm and AC, including information about the length of time a firm has an audit committee, size of firms (in term of total assets), the percentage of ownership of majority stockholders, the percentage of members of commissioners representing majority/controlling stockholders, percentage of directors representing controlling shareholders, and whether commissioners and directors are appointed by controlling shareholders.
2. The second part consists of information about composition of AC. It collects information about the size of AC, the number of AC's members who are not directors or employees, who do not have business with the firm, and who do not have shares in the firm, the financial background of AC, and the party that appoints members of AC.
3. The third part is the measure ACE, which is divided into four parts:
 - a. Interaction with external auditor. Information collected are the appointment of the auditor and its fee; the frequency, the length, and the privacy of meetings with the auditor; the extent of monitoring on the auditor.
 - b. Access to financial report and monitoring on policy compliance. Information collected is the degree of access to financial report and other information, the

degree of monitoring on policy compliance, such as policy on audit and non-audit service, taxation, environment, and legal issues.

- c. Interaction with internal auditor. The questionnaire collects information on the frequency and the quality of the meeting with the internal auditor, the extent of monitoring on the internal auditor, and the involvement of audit committee in reviewing the competency of internal auditors.
- d. Interaction with the board of commissioners and shareholders, and AC meeting. Information collected is the extent of meeting with the board and shareholders, accountability to the board, and the frequency of audit committee meeting.

To ensure that the questionnaire generates reasonably good data, we perform validity and reliability tests. To test the reliability of data we calculate Cronbach's alpha, which is a reliability coefficient that indicates how well the items in the questionnaire are positively correlated to one another. The closer Cronbach's alpha is to 1, the higher the internal consistency reliability. We calculate the Cronbach's alpha for each part of the questionnaire and the Cronbach's alpha ranges from 0.78678 to 0.8515. The coefficients are relatively high so we conclude that the data is reliable.

Validity refers to the degree that the measure includes an adequate and representative set of items that tap the concept. To test for validity, we calculate the corrected item correlation across observations for each question. The results show that all questions have correlation coefficient higher than the cut-off value, suggesting that validity for each question is fulfilled.

Measurement of Variables

The measurement of variables is based on the results of the surveys. Except for the first part of the questionnaire (the background information) each relevant question in the questionnaire is given a score from zero to five, depending on the answer to the question. Higher score means better ACE. For example, the scores for the average length of time of meeting between audit committees and external auditors are: 0 (no meeting), 1 (0 – 1 hour), 3 (1 – 2 hours), 5 (more than 2 hours). Each part of the questionnaire then has its total scores. For example, the maximum score for part 2 (composition of audit committees) is 40 points while for part 3a (interaction with external auditors) is 75 points. Since the maximum points differ across the parts, we standardize the score in each part by dividing the score by the maximum point, so the standardized score ranges from 0 to 1. For example, given that for a firm the score in part 2 is 30, the standardized score for that firm is 0.75 (i.e., 30/40).

Audit Committee Effectiveness

ACE is measured by the conduct of audit committees in term of its interaction with external auditors, its interaction with internal auditors, access to financial reports and monitoring on policy compliance, and interaction with board of commissioner and shareholders. The measure of ACE is the average of the standardized score of part 3a, 3b, 3c, and 3d of the questionnaire. This approach implies an equal weighting on each activities of AC.

Composition of Audit Committees

The measure of audit committee composition (COMP) is the standardized score of part 2 of the questionnaire.

Sample Selection and Data

As of June 2003, 282 out of 331 listed in the JSX have audit committees. We randomly sent questionnaires to 200 firms. To increase the response rate, we included a letter from the director of the JSX recommending the firms to fill out the questionnaires. The questionnaires were sent to audit committees of these firms. The distribution was done via postal mail, e-mail, or interviewing the chair of audit committees or member of audit committees. The period of distribution started from July 28, 2003 until October 26 2003. Unfortunately only 37 firms or 18.5% made a response and data on 33 firms that can be further processed.² The fact that the response rate is low may indicate low awareness of these companies on the importance of audit committee research in Indonesia. Since it is likely that firms that tend to response are firms that judge themselves as relatively good in their effectiveness, this may bias the results toward finding high audit effectiveness among the sampled firms.

EMPIRICAL RESULTS

Table 1 provides frequency distribution of the samples based on the independent variables (except COMP). The table shows that the majority of the samples (73%) have audit committees for less than 2 years. This implies that before the JSX required listed firms to form audit committees, these firms did not have audit committees. This may indicate that for the majority of the samples, the main reason they form audit committees is due to external pressure.

Next, confirming Claessen and Djnakov (1999) more than 50% of the firms are controlled by majority shareholders. The large control of majority shareholders on these

² Four questionnaires are invalid because several questions are not answered and some questions that should have had only one answer had more than two answers.

firms is even more salient if we look at other independent variables. The percentages of firms having more than 50% representation of majority shareholders in the board of commissioners and in the board of directors are both 81.80%. This indicates that in some firms majority shareholders ownership is less than 50%, but their representation in the boards is well exceed 50%. The dominance of majority shareholders in companies' affairs can also be seen in the appointment of the chairman of the board and the CEO. In almost 70% of the firms, the chairman and the CEO are directly appointed by the majority shareholders. The rest 30% is appointed through shareholders meeting and through the fit and proper test by independent parties.

Under this condition of majority shareholders' dominance and the fact that audit committees are appointed by the board of commissioners and are there to support the board, it will be difficult for audit committees to effectively fulfill their duties

Table 1
Frequency Distribution of the Samples based on the Independent Variables

No.	Independent Variables	Frequency	%
1.	The length of time a firm has a committee audit:	8	24.2
	a. Equal to or less than one year	16	48.5
	b. Between one to two years	9	27.3
	c. More than two years		
2.	The majority shareholders' ownership:		
	a. Less than or equal to 35%	4	12.1
	b. Between 35% to 50%	10	30.30
	c. More than 50%	19	51.5
3.	% of commissioners representing majority shareholders:		
	a. Less than 50%	6	18.2
	b. Between 50 to 60%	10	30.3
	c. More than 60%	17	51.5
4.	% of directors or management representing majority shareholders:		
	a. Less than 50%	6	18.2
	b. Between 50 to 80%	12	36.4
	c. More than 80%	15	45.5
5.	Chairman of the board and CEO are appointed by majority shareholders:		
	a. Yes	23	69.7
	b. No	10	30.3

Source: Leonardo (2004)

Descriptive Statistics of Scores of Audit Committees Composition and Effectiveness

The following table provides descriptive statistics of scores of audit committees composition and effectiveness. The effectiveness score is broken down into its components. The possible lowest score is zero and the highest score is 100.

Table 2

Descriptive Statistics – Scores of Audit Committees Composition and Effectiveness

Variables	Mean	Std. Dev	Minimum	Maximum
COMP	76.9	12.0	58	95
EFFECTIVE	59.3	13.9	31	78
External Audit	51.8	18.1	16	87
Internal Audit	54.1	18.3	15	88
Reporting and monitoring	60.2	20.1	33	97
Commissioners and shareholders	71.7	7.8	53	87

Source: Leonardo (2004)

The average score of audit committee composition is 76.9, which is reasonably good. Table 3 provides more detail information about the composition of audit committees. The table indicates that the majority of firms have three persons as members of audit committees – the minimum requirement by the JSX. Most of them are from outside the firms, have no business relation with the firms, and don't have shares in the company. All of them have at least one member whose background is in accounting or finance and even the majority of them have all members having background in accounting or finance. Almost all members of audit committees are appointed by the board of commissioners. However, as mentioned earlier, being independent and appointed by the board does not necessarily translate to more effective audit committees as the average score of effectiveness shows.

The overall average effective score is only 59.3 and ranges from the lowest of 31 to the highest of 78. Looking at the components of the score, the low score is primarily due to the weak interaction between audit committees and external auditors (51.8) as well as internal auditors (54.1).

Table 3
Frequency Distribution - The Composition of Audit Committees

Description	Frequency	Percentage
The number of audit committees:		
a. 3 members	28	84.9
b. 5 members	5	15.1
Members of audit committees from directors or employees:		
a. Yes	3	9.1
b. No	30	90.9
Members of audit committees that have business interest/relation with the company:		
a. Yes	5	15.1
b. No	28	84.9
Members of audit committees that have shares in the company:		
a. Yes	3	9.1
b. No	30	90.9
Background in Accounting or Finance:		
a. Only 1 out of 3/5	1	3.0
b. 2 out of 5	0	0
c. 3 out of 5	1	3.0
d. 2 out of 3	5	15.2
e. 4 out of 5	1	3.0
f. 5 out of 5	25	75.8
Audit committees is appointed by:		
a. Management	1	3.0
b. Board of Commissioners	29	87.9
c. Shareholders	3	9.1

Source: Leonardo (2004)

The low score of interaction with external auditors is due to:

1. Management still plays an important role in hiring and replacing the external auditors (15.2% appointed by the management and 42.4% by the management, recommended by audit committees).
2. The majority of audit committees (69.7%) do not review the experience and the qualification of senior external auditors.
3. The frequency of meeting with external auditors is low (60.6% of audit committees meet only once or twice during the year).
4. The average length of time of meeting is short (69.7% in less than one hour).
5. Management attends the majority of the meeting (66.7%).

6. Some audit committees do not perform some reviewing duties of audit committees, such as:
- a. The engagement letter of external auditors (48.5%).
 - b. The schedule of visit of external auditors (87.9).
 - c. Audited financial statements and audit opinion (27.3%).
 - d. Letter of findings from external auditors to management (48.5%).
 - e. Interim financial statements (51.5%).
 - f. Accounting and disclosure policy (24.25).
 - g. Legal issues and claim from external parties (51.5%).
 - h. Management compliance to internal control system and procedure (30.3%).

The low score of interaction with internal auditors is due to:

1. Audit committees need authorization from the management to have a private meeting with internal auditors (54.6%) and to review the internal control system (75.8%).
2. The frequency of private meeting with internal auditors is relatively low (78.8% is equal to or less than 4 meetings per year).
3. Audit committees are not involved in decision of terminating the chair of internal audit division (81.8%).
4. Some audit committees do not review the experience and qualification of internal auditors (33.3%).

The average score of access to financial report and monitoring on rule compliance is also not good (60.2). The majority of audit committees do not monitor litigation/lawsuit faced by the companies, complaints by external parties or consumers, and policy on environment and its compliance.

The only component of the effectiveness score that can be considered adequate is the interaction of AC to the board of commissioners and shareholders. The majority of AC attend general meeting of shareholders, report their activities to the board four times or more in a year (including the report on external auditors, internal auditors, and annual financial statements), and the report is submitted on time. However, only 18.2% of AC meet with the board more than four times per year.

Overall, audit committees in the sampled firms are not effective in performing their duties. This result is not consistent with the background of audit committees, which are fairly independent and competent. This inconsistent result may be due to other factors (such as the influence of the majority shareholders) that intervene the effectiveness of audit committees in performing their duties.

SUMMARY AND CONCLUSION

In Indonesia as well as in other parts of the world, issues related to corporate governance and audit committees are of considerable interest to regulators and the accounting profession. However, there is little empirical evidence about audit committee composition and audit committee effectiveness in Indonesia. This study attempts to provide such empirical evidence, based on a survey of audit committees of publicly listed companies in the JSX.

In our sample, we find that the majority of the companies comply with the JSX requirement about the minimum number of audit committee member (3 persons), their independence, and their competence (finance or accounting background). In addition, the majority of them are appointed by the board of commissioners.

However, having met the qualification requirement does not necessarily translate to high ACE. We find that audit committees in our sample are not yet effective in their authority, resources, and efforts. With regard to the components of ACE, we find that the interaction of AC with external auditors is the least effective while the communication to the board of commissioners and shareholders is the most effective. The interaction of AC with internal auditors and monitoring on compliance are also ineffective.

These results apparently are not consistent: on the one hand firms comply with regulation on AC composition; however, this compliance does not translate to higher ACE. One possible conclusion is that AC composition is not the only factor that determines ACE; other factors may also influence ACE and offset the impact of AC composition on ACE.

The policy implication of the study follows. By formulating regulation on AC composition is not enough to enhance ACE; this has to be accompanied by other policies that regulate other factors that determine ACE. What these factors are subject to empirical studies.

We now discuss some limitations of this study. First, our sample is very limited, so the results of this study may not be generalizable to all companies in the JSX. Second, this study is a survey and the respondents may provide information that differs from the reality, affecting the results of this study.

There are at least three possible avenues for future research. First, future studies should examine factors influencing ACE; Second, future studies should expand the sample of our study. Third, it would be interesting to examine the issues covered in this study in other East-Asia countries to see whether the results are consistent.

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