Title: The dynamics of financial reporting practice in an Indonesian insurance company: a reflection of Javanese views of an ethical social relationship

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# The dynamics of financial reporting practice in an Indonesian insurance company: a reflection of Javanese views of an ethical social relationship

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# THE DYNAMICS OF FINANCIAL REPORTING PRACTICE IN AN INDONESIAN INSURANCE COMPANY: A REFLECTION OF JAVANESE VIEWS ON AN ETHICAL SOCIAL RELATIONSHIP

**A thesis submitted in fulfilment of the requirements for the award of the degree**

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## CERTIFICATION

I, Anis Chariri, declare that this thesis, submitted in fulfilment of the requirements for the award of Doctor of Philosophy, the School of Accounting and Finance, University of Wollongong, is wholly my own work unless otherwise references or acknowledged. The document has not been submitted for qualifications at any other academic institution.

Anis Chariri
26 May 2006

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# ABSTRACT

This study is an ethnographic case study conducted in an Indonesian insurance company. The aim of the study is to understand the dynamics of financial reporting practice in the company. Ontologically, this study is built on a belief that financial reporting practice is a socially constructed reality. It is an institutional and political practice. As a socially constructed reality, such a practice involves an interaction among social actors, and between organisational actors and the institutional and cultural environment in which the company operates. The main research question of this study is why and how the company commits to quality financial reporting practice.

This study reveals that the company is committed to quality financial reporting because such reporting can be used to gain legitimacy and to maintain social harmony. The company conducts itself in this way is because it reflects Javanese culture, a dominant culture in Indonesia. Hence, financial reporting can be designed by a powerful actor so as to construct a rhetorical story about the company's actions by claiming that it complies with socially imposed beliefs, norms and values about how the company should act.

Furthermore, this study concludes that the way the actors in the company construct financial reporting practice is influenced by its organisational culture. The organisational culture of the company, which reflects Javanese culture, is able to shape the behaviour of its actors from the top level to lower levels to conduct ethical and transparent business practice. This culture also influences the way the actors respond to external pressures in regard to financial reporting practice.

In addition, this study concludes that the exercise of power and leadership in the company determines the construction of financial reporting practice. The Javanese philosophy of power and leadership has shaped such exercise of power and leadership. Leaders of the company have been able to show themselves as exemplary models for their subordinates (*ing ngarso sung tulodo*), as individuals who are able to empower subordinates (*ing madyo mangun karso*), and have a sense of responsibility to their subordinates (*tut wuri handayani*).

Finally, regardless of how beliefs, values and norms are institutionalised in the company to shape individual's behaviour, to influence the exercise of power and leadership, and then to socially construct financial reporting practice, this study reveals that financial reporting practice of the company is a socially dynamic process. It reflects the Javanese ideas on an ethical social relationship. Financial reporting practice in the company supports a claim that accounting is a social science. It is not value free, but a socially constructed reality.

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# CHAPTER ONE
# INTRODUCTION

## 1.1 BACKGROUND OF THE STUDY

### 1.1.1 Lack of Convincing Evidence

Financial reporting is purported to be a useful mechanism for managers to communicate with outside parties such as investors, creditors and financial analysts. From the perspective of usefulness to decision making, financial reporting should be able to present useful information to help investors and creditors make economic decisions. This perspective is consistent with the objectives of financial reporting proposed by authoritative bodies such as the US Financial Accounting Standard Board (FASB) in the Statement of Financial Accounting Concepts (SFAC No. 1) and the Australian Accounting Research Foundation (AARF) in the Statement of Accounting Concepts (SAC No. 1).

Usefulness to decision making implies that to provide the information users need, a manager, as a preparer of financial reports, should be able to communicate the information and safeguard its relevance and reliability. The relevant and reliable information supplied by financial reporting can also have significant effects for companies and for public confidence in capital markets (Bromwich 1992; Miller and Bahnson 2002). However, whether financial reporting is capable of providing sufficient and appropriate information to help users make economic decisions is questionable.

Conflicts of interests between managers and outside parties, especially investors, create distortions in financial reports. In fact, through "creative ways", managers are capable of manipulating accounting numbers to achieve their own objectives (Clarke, et al. 2003; Jennings 2003; Pijper 1993). This usually occurs when there is divergence in shareholders' and managers' objectives. Such divergence could motivate managers to make financial reporting decisions in their own interest and could provide incentives to distort reported profits (see Dye 1988; Schipper 1989; Watt and Zimmerman 1986). Some studies also provide evidence supporting this argument (Collins and DeAngelo 1990; Healy 1985; McNichols and Wilson 1988). As a result, financial reporting has been the subject of serious criticism in recent years.

The public has witnessed a number of well-known examples of accounting scandals and bankruptcy involving large and prestigious companies in developed countries. The media has reported scandals and bankruptcies in companies such as Sunbeam, Kmart, Enron, Global Crossing (USA), BCCI, Maxwell, Polly Peck (UK) and HIH Insurance (Australia). Besides scandals in developed countries, which have sophisticated capital markets and regulations, similar cases can be also seen in developing countries with emerging capital markets. As reported by Johnson, et al. (2000), Asian countries have experienced similar cases, such as PT *Bank Bali*, and *Sinar Mas* Group (Indonesia), Bangkok Bank of Commerce (Thailand), United Engineers Bhd (Malaysia), Samsung Electronics and Hyundai (Korea).

Theses cases imply that the corporations have failed to supply accurate information to their investors, and to provide appropriate disclosures of any transactions that would impact their financial position and operating results. Indeed, information provided in financial reports can be misleading. Accordingly, investors and other users of financial reports are raising questions about the quality and integrity of the financial reporting process (Dunn 2003) and about the usefulness of financial reports in helping investors make economic decisions.

In addition, the recent accounting scandals have induced a crisis of confidence in financial reporting practice and effectiveness of corporate governance mechanisms (Bartley 2002; Browning 2002; O'Connell, et al. 2005). A number of surveys point out that annual financial reports are not widely read by users nor used as the main source for making economic decisions (Anderson 1979; Anderson and Epstein 1995; Bartlett and Chandler 1997; CPA Australia 2002). Meanwhile, other studies have been directed towards investigating how to enhance the quality of financial reporting (Cohen, et al. 2004; Jonas and Blanchot 2000) and how information provided by financial reports affects market efficiency and individual behaviour (Amir and Lev 1996; Healy, et al. 1999; Lev and Ohlson 1982; Lev and Zarowin 1999).

Studies of financial reporting, as Mathews and Perera (1993); Ryan, et al. (2002) and Wolk, et al. (2004) note, have proceeded in several directions, such as a decision-usefulness approach (Gilman 1939; Grady 1965; Paton 1922; Paton and Littleton 1940), behavioural research (for example, Anderson 1979; Anderson and Epstein 1995; Chenhall and Juchau 1977; Lee and Tweedie 1975a; 1975b) and market-based accounting research (for example, Amir and Lev 1996; Botosan 1997; Francis and Schipper 1999; Healy 1985; Healy, et al. 1999; Lev and Ohlson 1982; Lev and Zarowin 1999). Moreover, studies of financial reporting have been dominated by the positive accounting research paradigm framework, which addresses particular problems to be analysed using mathematical and statistical techniques, and which is aimed at explaining and predicting how self-interested individuals behave when facing economic consequences of particular accounting issues (Holthausen 1990; Watt and Zimmerman 1986). Studies of financial reporting have also raised concerns about the roles of corporate governance mechanisms, auditors and regulators in monitoring managers' behaviour (Berle and Means 1975; Cohen, et al. 2004; Fama and Jensen 1983; Forker 1992; Jensen 1986; Jensen and Meckling 1976; Weir, et al. 2002; Williamson 1985b).

However, empirical studies have not provided conclusive and convincing evidence to support the claims made for the usefulness of financial reporting. For example, findings of empirical studies on the association between a corporate governance mechanism and quality financial reporting showed contradicting evidence (see for example, Beasley 1996; Beasley, et al. 2000; Chen and Jaggi 2000; Dunn 2003; 2004; Forker 1992; Goodwin and Seow 2002). The studies produced different results, but they did not provide conclusive and convincing explanations for such different findings.

There might be some reasons for the mixed evidence. One might be that the nature of instruments used to measure variables affecting transparent financial reporting is based on a proxy, such as the presence of an independent board of directors and audit committee, the proportion of their independent members and the size of the board or committee. Therefore, such different measures could result in different conclusions. Watt and Zimmerman (1986) also have acknowledged that the application of vague proxies, different sample sizes, and incorrectly specified functional models have produced inconclusive and mixed results. The differences in research findings might also be because of differences in the time period of the studies or the cultural environment of countries (Adams and Kuasirikun 2000; Chen and Jaggi 2000; Hofstede 1987; Perera 1989), and the cultural uniqueness of organisations (Geriesh 2003; Loebbecke, et al. 1989; Merchant 1987; Rezaee 2002).

It has been argued that the presence of a corporate governance mechanism does not guarantee transparent financial reporting practice (Fogarty and Kalbers 1998; Tricker 1994a). The effectiveness of a control mechanism depends on values, norms and beliefs accepted in an organisation (Jennings 2004a; 2004b; 2005a; Oliver 2004) and the involvement of actors in control structures in monitoring managers (Cohen, et al. 2004; Jennings 2005b). However, none of those studies tries to analyse financial reporting practice from a perspective of the power exercised by actors in the corporate governance structure, and institutional factors such as regulations and rules. This might be because of the commonly made claim that accounting is merely concerned with matters of fact and efficiency. Tinker (1988) contends that problems of accounting are associated with the way in which marginalist economics has colonised the notion of efficiency. This implies that accounting is seen as representation of "itself, variously, as 'technical', 'neutral', and 'value free'" (Munro 1998, p. 201).

However, accounting is no longer seen by some as "a neutral device that merely documents and reports 'the facts' of economic activity" but as "a set of practices that affects the type of the world we live in, the type of social reality we inhabit" (Miller 1994, p. 1). Financial reporting practice is influenced not only by economic variables as claimed by the proponents of positive research, but also by institutional, political and cultural environments. It is recognised that the current research in accounting and corporate governance is alert to the fact that actors' behaviour is modified by procedures, rules, incentives and other economic factors. Most research to date has all but ignored the institutional, political and cultural environment in which financial reporting practice takes place. Consequently, calls for studying financial reporting within its environmental contexts have emerged in accounting literature (Adams 1997; Gray 1988; Rezaee 2002; Miller 1994; Munro 1998).

### 1.1.2 The Need for Further Study

Considering the above view, a further study is necessary to understand and analyse the dynamics of financial reporting practice from the perspective of a corporate governance mechanism involving institutions, power and culture. Such research should be directed to understand how power is exercised by actors in a corporate governance mechanism, and how institutional pressures and organisational beliefs, values, and norms influence financial reporting practice of a company.

The above views insinuate that financial reporting practice should be studied within the framework of an interpretative, rather than a positivist, paradigm. Such a study is attainable because accounting can shape and be shaped by the environment in which it takes place, and because accounting procedures are intertwined with interpretation and understanding (Mouck 1992). Indeed, managers and other organisational actors who construct financial reporting are both influenced by and influence the environment (Mangos and Lewis 1995). Moreover, Hopper, et al. (1995, p. 528) highlight that

> ...in communicating reality accountants simultaneously construct it (Hines 1988) and accounting is a social practice...and not merely a market practice guided by equilibrium in an efficient market.

Hopwood, et al. (1994, p. 228) also claims that "...*accounting* is intimately implicated in the construction of facilitation of the contexts in which it operates. It cannot be extracted from its environment like an individual organism from its habitat"[original emphasis].

Studying financial reporting practice from the perspective of institutions, power and culture can enhance prior studies of financial reporting practice that have been focused on technical and economic issues. Cooper (1980) and Tinker (1980) insist that the scope of accounting research should be broadened beyond traditional positivist investigations with its technical-efficiency focus to incorporate social and political phenomena. In a similar vein, Neu (1992) argues that accounting studies should go beyond the traditional positivist investigation to encompass socio-political factors.

More recently, Geriesh (2003) and Cohen, et al. (2004) also suggest that further research of financial reporting should focus on the political, social, and cultural forces that influence accounting decisions. These views are shared by Hopwood, et al. (1994, p. 228) who opine that "accounting cannot be isolated and analysed as practice that is free from culture. The existence of accounting is determined by culture, customs, norms, and institutions".

To date, what has been studied in accounting is how power and institutions influence individual behaviour in decision making within a management accounting framework, such as in budgeting (Bartlett 1980; Covaleski and Dirsmith 1986; Pfeffer and Salancik 1974), and how power and culture affects interested parties in accounting standard setting, such as those of the US (Puro 1984; 1985; Sutton 1984; Tandy and Wilburn 1992; 1996), the UK (Hope and Gray 1982; Nobes 1991; Sutton 1984), Australia (Klumpes 1994; Walker and Robinson 1993; 1994), New Zealand (Rahman, et al. 1994) and Germany (McLeay et al. 2000). What is missing from the prior studies is research into the relation between institutions, power and culture in financial reporting practice of an organisation.

The argument in this study is built on a belief that accounting is a socially constructed reality (Hines 1988; Miller 1994; Morgan 1988; Munro 1998; Neimark and Tinker 1986). In line with financial reporting, such practice involves interactions among organisational actors; and between the actors and external institutional environment/constituents. It is the institutional environment that shapes financial reporting practice, and it is the people who process information, make judgment and decisions regarding information presented in financial reports. This means that corporate financial reporting is a dynamic process—a continuous conversation.

This study claims that financial reporting practice is an institutional and political practice concerning the supply of information, and that it takes place in a political arena involving rules of the game (regulations/rule), culture and players (interested parties). As Guthrie and Parker (1990, p. 166) argue

> the political economy perspective perceives accounting reports as social, political and economic documents. They serve as a tool for constructing, sustaining and legitimising economic and political arrangements, institutions and ideological themes.

In addition, Baker and Bettner (1997, p. 293) point out that

> accounting capacity to create and control social reality translates into empowerment for those who use it. Such power resides in organisations and institutions, where it is used to instil values, sustain legitimising myths, mask conflict and promote self-perpetuating social orders…Contrary to the public opinions, accounting is not a static reflection of economic reality, but rather is highly partisan activity.

Accordingly, the dynamics of financial reporting practice might be better understood by analysing how players behave in organisations according to norms, values and beliefs accepted in the organisation, and how external institutional pressures influence the actors in financial reporting practice.

Within the mechanism of corporate governance, at least, five players are involved in making judgments on financial reporting: managers, boards of directors, audit committees, internal auditors and external auditors. However, it can be argued that owners, especially controlling shareholders or founders (mostly in developing countries) might also be intensively involved in determining the information disclosed in financial reports. Even so, it is believed that although all players may have convergent objectives, power in organisations tends to be dominated by managers. Crowther (2002, p. 44 note 5) argues that:

> when considering power in the context of a disciplinary practice of surveillance (Foucault 1977) through the use of the reporting mechanisms of accounting, it is clear that the majority of power resides in the managers of the organisations who control and distribute this reporting to other stakeholders in the manner they choose. It is recognised however that legislatory and regulatory requirements provide a limit to their ability to control this information and pose demands upon the reporting framework.

The previous examples of accounting scandal and bankruptcy, such as Enron and HIH Insurance, showed that boards of directors, audit committees and external auditors seem unable to monitor and supervise managers to act in the interest of shareholders (Fox 2003; HIH Royal Commission 2003; Miller and Bahnson 2002).

Further, a study of the dynamics of financial reporting practice by involving institutions, power and culture could make a significant contribution to studies on financial reporting practice. This is because such a study could provide insights into how institutional pressures and culture influence financial reporting practice, and how power is distributed and exercised by actors in an organisation to determine contents, formats and disclosures of financial statements and explain why certain companies are committed to quality financial reporting. The only studies considering power in financial reporting are those by Dunn (2004), Fogarty and Kalbers (1998) and Kalbers and Fogarty (1993); whereas a study concerning institutional aspects of financial reporting was undertaken by Mezias (1990).

However, Dunn (2004) only investigated power from insider perspectives and found that the decision to issue fraudulent financial reports is more likely to occur when there is a concentration of power in the hands of insiders. On the other hand, studies by Fogarty and Kalbers (1998) and Kalbers and Fogarty (1993) only considered power of the audit committee and neglected how power is exercised and mobilised in an organisation to influence financial reporting practice.

In relation to institutional aspects, Mezias (1990) only investigated the influence of institutional variables on the recording of the income statements for financial reporting purposes of the investment tax credit (the use of the flow-through method versus the deferral method). This study neglected a social and political process by which a certain method was adopted.

Studies by Fogarty and Kalbers (1998) and Kalbers and Fogarty (1993) concluded that it is difficult to measure power and suggested that research should be undertaken by using an indepth interview approach; whereas Mezias' (1990) study suggested that further work in an institutional setting is required to improve understanding of institutional effects on organisations. Such suggestions imply that studies of financial reporting practice within its environmental context should employ a qualitative approach and should be conducted in an organisational setting.

## 1.2 THE REASON FOR A STUDY IN AN INDONESIAN SETTING

### 1.2.1 A Lot of Regulations but Weak in Law Enforcement

Indonesia is the world's largest archipelago, the world's fourth-largest nation, and its population consists of different ethnic groups including Javanese (45 per cent) Sundanese (14 per cent), Madurase (7.5 per cent) and coastal Malays (7.5 per cent) (ADB 2003). After being colonised by the Netherlands (350 years) and Japan (3.5 years), Indonesia declared independence on 17 August 1945. In respect to economic activities, the government is seen as a major actor in Indonesia's market-based economy. Following its independence, Indonesia experienced rapid economic growth and has been regarded as an emerging capital market. Indonesia also changed from using a Dutch to a US accounting practice.

In spite of an abundance of natural resources and growth rates of seven to eight per cent in the early 1990s, Indonesia has faced a number of economic problems, including the practice of accounting, auditing and financial disclosure (ADB 2003). Pressures for improvement of financial reporting practice grew in the wake of a series of financial reporting scandals such as Bank Duta (early 1990), Plaza Indonesia Realty (mid 1992) and *Barito* Pacific Timber (1993)[1]. In addition, an empirical study showed that the level of disclosure in annual reports of Indonesian companies for the year ended 1993 was 55 per cent of international accounting standard disclosure (Craig and Diga 1998).

To avoid similar scandals and to develop a capital market for mobilising long-term investment flows, the Indonesian government and professional bodies

[1] For detailed discussion see ADB (2003)

have developed regulations governing both the capital market and accounting. As a result, in September 1994, the Accounting Standard Committee of the Indonesian Institute of Accountants (KPSAK) released a new set of accounting standard called *Pernyataan Standard Akuntansi Keuangan* (PSAK). The new standard (PSAK) replaced the 1984 Indonesian accounting standards called *Prinsip Akuntansi Indonesia 1984* (PAI 1984)[2]. However, KPSAK adopted the international accounting standards without doing any preliminary research to determine whether the standards are compatible with the Indonesian environment and whether those standards are capable of improving the quality of financial reporting in Indonesia[3]. The government also issued Corporate Law No 1/1995 in March 1996 to replace corporate law codified in Indonesian Commerce Law called *Kitab Undang-Undang Hukum Dagang,* which was translated from Dutch commercial laws.

Under the new law, nonetheless, whether the quality of financial reporting in Indonesia is higher than before is still in question. In fact, a number of corporate scandals occurred not long after the release of new regulations/law. A

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[2] Pre-1973 financial requirements were prescribed by Dutch-based company law that required only that "adequate financial records be kept". In 1973, the Indonesian Institute of Accountants (IAI) released *Prinsip Akuntansi Indonesia* (Indonesian accounting principle)—commonly called PAI-1973 that reflected the 1965 US generally accepted accounting principles (GAAP). In 1984, IAI revised *Prinsip Akuntansi Indonesia* and issued the *1984 Prinsip Akuntansi Indonesia* (PAI-1984). In 1994, through the Seventh National Congress of IAI, Indonesia has adopted International Accounting Standards as the basis for domestic financial reporting (ADB 2003; Chariri and Ghozali 2002).

[3] In an emerging capital market, financial reporting has been increasingly viewed as a vital infrastructure for the growth of capital. Although the markets are characterised by both structural problems such as small size of market capitalisation, low liquidity and limited investment choices, and political and economic problems associated with political risk and uncertainty, unfavourable government regulation and macroeconomic stability, quality financial reporting plays an important role in attracting international investors (for a detailed discussion see Saudagaran and Diga (1997). This is because the quality of financial reports enables investors to reduce potential risks caused by the political and economic problems.

number of instances of business misconduct, especially concerning the lack of transparency in publishing relevant and reliable information, are evidence of such scandals. This can be seen from the cases of collection of private funds to support the N-2130 jet aircraft project of IPTN[4] (McLeod 1997), privatisation processes including private provision of public services (World Bank 1997) and the *Bapindo*/Golden Key scandal of 1994–1996[5] (Cole and Slade 1996). The 1997 Indonesian economic crisis with the collapse of the Indonesian Rupiah was the ultimate result of a series of accounting and corporate scandals. This crisis, which made many of the country's conglomerates technically collapse (ADB 2003) and made the Indonesian government lose legitimacy with the fall of President Suharto's dynasty in 1998, further increased pressure for the government to improve the quality of financial reporting.

On August 1999 through the Decree issued by the Minister of Economics, Finance and Industry No.10/M.Ekuin/08/1999, the Indonesian government established the National Committee on Corporate Governance (NCCG), which is responsible for developing a framework of good corporate governance for the Indonesian business environment. As a result, in March 2000, The NCCG released "the Code of Good Corporate Governance/Rev. 4.0" as guidance for companies in running a transparent, responsible, accountable, and fair business.

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[4] IPTN is the National Aircraft Maker, a mega project, which was built by Habibie, the Minister for the Development of Technology during the era of President Suharto. In 1994 Suharto took $190 million from a reforestation fund to support the sagging state aircraft maker. However, this project was seen as failure.

[5] The Indonesian public witnessed that this scandal involved Sudomo, the chair of the Supreme Advisory Council and the former Minister for Politics and Internal Security Coordination during the era of President Suharto. Sudomo issued *Surat Sakti* (a special letter of reference) that allowed Edy Tanzil (a businessman) to take illegally money from Bapindo Bank.

This includes good corporate governance principles and guidelines concerning the role of the board of directors, audit committee, corporate secretary and corporate disclosure. The NCCG is also responsible for initiating regulatory reform. To support such reform, *Bapepam* (the capital market supervisory agency) and other authoritative bodies, such as the Indonesian Institute of Accountants, issued other regulations and accounting standards.

Even though a number of regulations have been issued to regulate financial reporting and business practice in Indonesia, they have not been able to ensure sound business practice and transparency in financial reporting. Implementation of regulations has not been smooth, and is impeded by weak law enforcement (ADB 2003). Disappointing implementation and weak enforcement might not be able to force companies to publish quality financial reports. Such weak law enforcement has led a number of companies to create and use “their own systems”, which often neglect good corporate governance principles and ethics. Consequently, within unethical and corrupt governance, it can be argued that commitment to quality financial reporting and compliance with regulations is largely determined by companies themselves within their own ethical culture.

Although a number of regulations have been released to improve financial reporting quality in Indonesia, none of studies in the Indonesian environment was directed to consider the relationship of institutions (regulations/rules) and financial reporting practice. Most accounting studies in Indonesia have been directed to investigating the relationship between economic factors, such as ownership structures, company sizes, industry types and financial performance and disclosure (for example Arifin 2002; Fitriani 2001; Marwata 2001; Susanto 1992). However, as with other empirical studies of accounting, the studies resulted in inconclusive and contradictory findings. Using Tinker's (1991) words, accounting research in Indonesia has been "colonised by the notion of efficiency". It is apparent that there is an institutionalised myth in the Indonesian accounting research community that accounting studies are considered to be outstanding only when they are conducted by employing "sophisticated statistical models".

Studies of financial reporting in the Indonesian setting tend to ignore the cultural beliefs and values accepted in Indonesian society. Nevertheless, as the language of business, accounting is not value free. Hofstede's (1982) study concluded that local culture influenced the behaviour of the Indonesians both in business and government institutions. This "local culture" refers to Javanese culture (Yudianti and Goodfellow 1997).

### 1.2.2 The Dominance of Javanese Culture

It has been documented that dominant culture in a society imposes pervasive influences on individual and corporate behaviour (Hofstede 1987; Kanungo and Mendonca 1996; Schein 2004). In the Indonesian business environment, it is claimed that Javanese culture is dominant in influencing the behaviour of Indonesian people (Antlov 1994; Magnis-Suseno 1997; Mann 1996; Mulder 1994; Yudianti and Goodfellow 1997).

The maintenance of social harmony is the core value of Javanese culture. To maintain social harmony, a social relationship of the Javanese is characterised by two basic principles indicating the Javanese ideas of the good life: conflict avoidance and respect (this will be further discussed in Chapter Three). The principle of conflict avoidance and principle of respect are manifested in the Javanese social life in terms of a hierarchical position and collectivism (Chapter Three will elaborate these issues). Such manifestation can be seen in social relationships in the Indonesian environment both in business organisations and in government institutions (Hofstede 1982)[6]. Indeed, the "socio-cultural environment determines management beliefs, values and assumptions of workers and work behaviour that characterise the organisation's work culture" (Kanungo and Mendonca 1996, p. 109).

Moreover, Javanese culture influences how individuals exercise power to lead and direct people in an organisation. The concept of a leadership style based on Javanese culture is built on a belief that a leader is a figure of *Bapak*-father and an exemplary model for their subordinates (Chapter Three will elaborate on this concept). To maintain social harmony, a leader will focus on collectivism in making a decision. In fact, as Marsh and Goodfellow (1997) emphasise, two important concepts about the leadership and decision making process in Javanese culture: *musyawarah* (mutual deliberation) and *mufakat* (the common unanimous decision) should be considered when a leader is making a decision. This is

[6] It should be noted that even though Javanese culture has an ethical view on a social relationship, this culture could be misleadingly interpreted and implemented in practice for self-interest at the cost of others. The leadership of President Suharto and his cronies in government institutions was an example of the misinterpretation of Javanese culture (See Marsh and Goodfellow 1997; Liddle 1996).

because the outcomes of decision-making are ultimately for *kepentingan bersama*-public interests/benefits (Magnis-Suseno 1997).

As culture is learned and derived by individuals from a social environment throughout their lifetime, Javanese culture is reflected in Indonesian social relationships, such as workplaces, political organisations and other institutions including financial reporting practice. March and Olsen (1989, p. 22) highlight that "behaviour is contained or dictated by cultural dicta and social norms. Actions are often based more on identifying the normatively appropriate behaviour than on calculating the return expected from alternative choices".

Because financial reporting practice, as a part of accounting activities, is value laden (Hines 1988; Miller 1994; Morgan 1988; 1998; Munro 1998), the use of Javanese ideas of an ethical social relationship will be useful to understand how quality financial reporting has been practised in a company. Jaggi (1975) claims that the value orientation of managers greatly influences them in making financial disclosures, and that value orientation of individuals in a society to a large extent is affected by the social environment of the society.

Studies of financial reporting that consider the cultural context in the Indonesian setting include those by Sudarwan and Fogarty (1996; 1997) and Tabalujan (2001; 2002). Sudarwan and Fogarty (1996) investigated the relationship among the cultural characteristic of Indonesian society, reporting practices and accounting standards promulgated by KPSAK. It was suggested that the development of accounting standards and disclosure practices were patterned by change in cultural norms (Sudarwan and Fogarty 1996). However, as they mentioned, their study suffered from certain weaknesses such as their inability to conduct an analysis of the influence of firm's specific culture on financial reporting practice. In addition, it is suggested that culture and accounting may be more dynamic than suspected and there may be "important qualitative aspects of the social relations" that underlie financial reporting practice that have been ignored by researchers (Sudarwan and Fogarty 1997, p. 214).

A study by Tabalujan (2001) also confirmed that culture influenced the practice of transparency in Indonesia. Tabalujan (2001) analysed practice of corporate governance (in terms of responsibility, accountability, fairness and transparency) in three Indonesian banks and concluded that such practice still diverged significantly from the stated principles of corporate governance. Such divergence, as he (2001) argues, might be due to local culture.

Elsewhere, Tabalujan (2002) analysed the impact of local culture on corporate governance practice in 259 companies listed on the Jakarta Stock Exchange in mid 1997 and 2001. He (2002) concluded that corporate governance practice was influenced by family relationship, one characteristic of Javanese values (Yudianti and Goodfellow 1997). In addition, a study by Hofstede (1982) confirmed that the four cultural dimensions (power distance, conflict avoidance, individualism/collectivism and masculinity/femininity) of Indonesian society are closely related to the characteristic of Javanese culture. This is why this study considered financial reporting practice in a company from a perspective of Javanese culture.

## 1.3 RESEARCH PROBLEMS

Efforts made by the Indonesian government and professional and accounting bodies have been intended to achieve a clean and fair business practice where no one gains benefit at the cost of others. However, it is recognised that despite significant improvement to the corporate governance framework during the 1990s, actual corporate governance behaviour during that decade diverged substantially from stated principles (Tabalujan 2001). A number of financial reporting problems still occur in Indonesia.

One publicly debatable case of financial reporting is the case of Lippo Bank, which published two different financial reports to the public and to *Bapepam* in 2002 (Antara 2003a; 2003b; Donnan and Hidayat 2003), although the bank had an independent board of directors and audit committee. Furthermore, during the period of 2002, there were more than 20 companies provided misleading information (*Bapepam* Annual Report 2002). *Bapepam* also reported that until the deadline of annual report submission, 31 March 2002, 87 companies (23.26 per cent of listed companies) had not submitted their annual financial statements to *Bapepam*. This figure increased to 30 per cent of listed companies (117 companies) in 2003.

On the other hand, it is recognised that some companies have published quality financial reports and awarded by *Bapepam* as the companies with the best annual reports. *PT. Asuransi Bintang, Tbk* (hereafter *Bintang*), a publicly listed insurance company, is an example of a company which publishes annual reports transparently and has been a recipient of annual report awards since the 1980s.

This particular company was selected as the research setting in this study. The reason for choosing *Bintang* as a research setting is that as a publicly listed company, it has a unique culture. Furthermore, *Bintang* has been successful in implementing a corporate governance mechanism that drives its organisational members to commit to quality financial reporting practice. This can be inferred from its ability to cope with the Indonesian economic crisis while many other companies went bankrupt, and from its success in winning a number of annual report awards.

Hence, instead of studying companies with fraudulent financial reporting, which has been investigated by a number of empirical researchers, the current study focuses on a company with the best annual reports. In other words, this study seeks to understand why, within a dirty and corrupt environment[7], this particular company is committed to quality financial reporting practice, whereas other companies engage in unethical and fraudulent financial reporting. By understanding the financial reporting practice of *Bintang* and its organisational uniqueness, this study aims to seek answers to the following specific questions:

**Why is the company committed to quality financial reporting?**

**How does the company construct its financial reports to deliver a message to its audience?**

**To what extent do external institutional pressures, such as regulations/rules, force the company to provide information in financial reports?**

**In what ways do intra-organisational dynamics, such as beliefs, values, norms, power and leadership, influence financial reporting practice?**

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[7] See International Corruption Watch, which ranked Indonesia as one of the most corrupt countries.

## 1.4 RESEARCH OBJECTIVES

Understanding the dynamics of financial reporting practice is not easy. The starting point for this study is the belief that financial reporting practice is an institutional and political practice. As a part of accounting systems, it is a socially constructed reality. From this view, financial reporting practice can only be developed by reference to the particular setting in which it is embedded (Burchell, et al. 1980; Hopwood 1983; Miller 1994). Thus, following Nahapiet (1988), this research was guided by a desire to develop an understanding of the way people communicate, behave and act in their everyday life and how this affects and is affected by financial reporting practice. This means that the study does not set out to test a set of specific hypotheses, but to observe and describe the actions and views of organisational members of *Bintang* and to identify the meanings underlying such actions (Burchell et al. 1980; Harre and Secord 1972; Nahapiet 1988). Following a view expressed by Hopwood (1983), such a study must be directed at financial reporting practice in an organisational setting.

This study is therefore not directed to generalise the dynamics of financial reporting practice in Indonesia. Instead, it is intended to understand in depth the dynamics of financial reporting practice in *Bintang* from the perspective of institutions, power and organisational culture within the framework of Javanese culture at large. In particular, this study intends to understand:

1. The reasons of and processes by which *Bintang* construct financial reporting

2. The organisational and institutional factors that influence financial reporting practice of *Bintang*
3. The extent to which there is institutionalisation of values, beliefs, and norms in *Bintang*
4. The exercise of power by the actors involved in the corporate governance mechanism in shaping financial reporting practice of *Bintang*.

**1.5 SIGNIFICANCE OF STUDY**

This study can be seen as a first attempt to understand and financial reporting practice from an institutional and power perspective within a framework of the dominant culture in Indonesia—Javanese culture. Consequently, the significance of the present study comes from two sources. First, the concepts developed here are relatively new to financial reporting studies. As such, the study represents a first effort to familiarise accountants with organisational uniqueness, power politics and a unique culture in financial reporting practice. This study can enhance sociological studies on accounting and develop the understanding of accounting knowledge and practice within social, political, institutional and cultural contexts. For the purpose of this theoretical exercise, the results of the literature review bring together a diversity of research efforts in financial reporting and provide a contribution to other studies in several disciplines.

Second, findings of the study could help industry groups, insurance regulators (the Directorate General of Financial Institutions), accounting standard setters (*Bapepam* and the Indonesian Institute of Accountants), and others to better determine the reporting requirements of insurance companies, and assist them to develop more effective regulatory initiatives such as regulations on disclosure and type of enforcement.

## 1.6 STRUCTURE OF ANALYSIS

In order to explore and explain the dynamics of financial reporting practice, it is desirable to have a coherent structure of analysis. This study is developed in eight main sections. At the outset, the second chapter will critically review current studies on financial reporting. Such a review is not a new idea, but by critically evaluating the existing studies of financial reporting, it will be clear why this study adopts an approach different from positive accounting research.

Next, the third chapter will discuss the theoretical background underlying this study. The use of institutional theory and power mobilisation by Hardy (1996) is perceived useful as a lens of understanding financial reporting practice, because ontologically, this study claims that financial reporting practice is a socially constructed reality providing the supply of information. Furthermore, this chapter will describe Javanese views on an ethical social relationship.

Chapter Four describes the integrated theoretical framework and the research approach employed in this study. Chapter Five portrays the historical background of *Bintang* used as the research setting. The following three chapters analyse why and how the company is committed to a quality financial reporting practice.

Chapter Six is directed towards a description and analysis of why *Bintang* commits to quality financial reporting practice, and how the company constructs its annual reports to gain legitimacy and maintain social harmony.

Chapter Seven describes and analyses how institutional pressure and cultural environment influence financial reporting practice and how the actors of *Bintang* construct organisational structures and culture and institutionalise beliefs, values and norms to respond to the pressure and environment. The Javanese ideas on social relationships are used in this chapter as a basis of analysing organisational culture and financial reporting practice of *Bintang*.

Chapter Eight is directed towards an understanding of the powerful actors behind financial reporting practice of *Bintang*. The Javanese philosophy on power and leadership will be employed to help understand how the powerful actors in *Bintang* lead their subordinates and mobilise power to drive organisational members to commit to quality financial reporting practice.

Finally, a conclusion is drawn in Chapter Nine to summarise findings of the study. This chapter also discusses limitations of the study.

# CHAPTER TWO
# CURRENT STUDIES OF FINANCIAL REPORTING: POPULAR DOES NOT MEAN PERFECT

## 2.1 INTRODUCTION

Current claims about the nature of accounting show that financial reporting is a technical activity concerning the supply of information. This implies that financial reporting is a static and deterministic practice involving procedural and clerical activities only. However, it will be argued that financial reporting is a dynamic process; that it is an institutional and political process concerning the supply of information; and that it is influenced by the cultural, political and social environment in which financial reporting takes place.

This chapter will discuss studies of financial reporting. The first section will describe the scope of financial reporting: its myths and reality. The second section will discuss studies of financial reporting within a positive paradigm and its weaknesses. Next, alternative approaches taking into account the environmental context of reporting will be discussed.

## 2.2 FINANCIAL REPORTING

### 2.2.1 What is Quality Financial Reporting?

Financial reporting is a medium for an organisation to communicate the past activities, results of operation and the future activities of the organisation to outside parties. Financial reporting consists primarily of audited financial statements prepared in accordance with generally accepted accounting principles. However, the scope of financial reporting covers not only the audited financial statements, but also other matters related directly or indirectly to information provided by accounting systems of an entity. According to Wolk et al. (2004, p. 288), financial reporting is used as "an umbrella term to cover both financial statements themselves and the additional types of information..."

Although a number of efforts have been made to improve financial reporting, there is a lack of consensus as to what constitutes financial reporting quality (Cohen, et al. 2004). The current claim is that quality financial reporting is based on qualitative characteristics set by the regulatory bodies and the quality is achieved in accordance with generally accepted accounting principles and generally accepted auditing standards. Such characteristics include relevance, timeliness, reliability, verifiability, representational faithfulness, neutrality, comparability and consistency, materiality, feasibility or costs and benefits, and transparency.

Miller and Bahnson (2002) consider the quality of financial reporting from capital market perspectives focusing on voluntary disclosure. They (2002, p. xviii) point out that quality financial reporting is a means by which companies report

> ...as much useful financial information as possible to the capital markets, including the public, the stockholders, and the company's creditors…by voluntarily providing market value-based and other information that the capital markets consider to be useful for assessing the value of the company's securities.

According to this view, financial reporting is concerned not only with the shareholders' interests, but also with the public's interests. Quality financial reporting is focused on the development of an efficient capital market. It is intended to enable market players to measure share prices traded in the capital market. Miller and Bahnson (2002) continue to argue that quality financial reporting

> ...is intended to reduce the cost of capital by stimulating demand for the company's stock, by reducing the capital markets' efforts in generating and analysing their own alternative information, by otherwise decreasing uncertainty about the company's future, and by building a new trust-based relationship with the stockholders and creditors. (p.xviii)
>
> the essence of QFR [quality financial reporting] is that managers will be able to raise capital at lower cost and enjoy many other advantages when they reach out to the capital markets and pull them into the inner circle [the company]... (p.xxii – xxiii)

What Miller and Bahnson (2002) mean is that the only way to produce quality financial reports is by providing more information beyond the minimum requirement set by laws/regulations, and that such information must be focused on market-value information to create capital market efficiency. This concern is concentrated on the future-oriented information, rather than the way of presenting the information. In regard to disclosure and the way of presenting information in financial reports, Bromwich (1992, p. 215-216) claims that

> ...[it] does not matter how information is disclosed. It is information itself, which matters. Thus accounting information is seen as merely one possible source of information which may often repeat items already available from other sources. With this view, disclosure via accounting reports of information not available from other sources would seem likely to improve decision making...It is the information itself which is of concern, not how it is presented. Any new information contained in published accounting reports will be discovered quickly in efficient markets, irrespective of how or where the information is positioned in accounting statements.

This assertion is similar to the arguments by Wolk*,* et al. (2004). They believe that the ability of a firm to raise capital will be improved if the firm has a good reputation with respect to financial reporting. Wolk*,* et al*.* (2004, p. 97) continue to claim that

> [c]ompetitive pressures would also force other companies to report even if they did not have good results...Companies with neutral news would be motivated to report their results to avoid being suspected of having poor results...Such a situation would also force 'bad news' firms to disclose results in order to maintain credibility in the capital market.

Quality financial reporting can be achieved if in designing a financial reporting system, managers are aware of and recognise the cause and effect of publishing either good or bad financial reports. Miller and Bahnson (2002) argue that four axioms can influence the perception and behaviour of managers in publishing financial reports. The four axioms include (Miller and Bahnson 2002, p. 6):

1. incomplete information creates uncertainty
2. uncertainty creates risk for investors and creditors
3. risk makes investors and creditors demand a higher rate of return
4. a higher rate of return for investors and creditors is a higher cost of capital for the firm and produces lower securities prices.

The four axioms imply that quality financial reporting will enhance investor's confidence in the capital market when quality financial reporting produces complete information. Such information will eventually decrease risks and enhance certainty in regard to an investment atmosphere in the capital market (Miller and Bahnson 2002). By considering such axioms, managers can choose certain strategies for financial reporting regarding a company's financial position, the result of operations and relevant disclosure. For Miller and Bahnson (2002), the strategies must be directed at enhancing investors' confidence and promoting capital market efficiency. Miller and Bahnson (2002, p. 9) assert that a manager can choose between the following two strategies:

> 1. manage the company in such a way that you [managers] will increase the potential cash flows to be realised in the future [or]...manage the company... you [managers] would like, paying little attention to the present and future cash flows...
> 2. provide financial statements that are so complete, timely, trustworthy, and thoroughly informative that they reduce uncertainty faced by the investors and creditors [or]... try to use GAAP or financial reporting policy choices to present financial statements that make [the] company look more attractive than it really is...

It is believed that because of opportunistic behaviours, managers might prefer to pay little attention to the present and future cash flows and use accounting policies that make a company look more attractive. Indeed, Revsine (1997, p. 28) posited that when publishing financial reports,

> managers prefer reporting methods that provide latitude in income determination...rather than methods that tightly specify statement numbers under given economic conditions. By providing managers with control over when they can report externally driven events, loose reporting standards can be used by managers to increase compensation, and to hide perquisite consumption, incompetence, or laziness.

Revsine (1997, p. 28) continues to argue that

> ...manager's preferences for "loose" financial reporting standards also arise for reasons other than bonuses. These include, for example, enhancing reported performance in an attempt to (1) impress shareholders and (2) protect their jobs by forestalling takeovers.

This phenomena leads us to question whether the current practice shows quality financial reporting and does management show ethical behaviour in presenting financial reports?

### 2.2.2 Quality Financial Reporting: Myths and Realities

Even though endeavours have been directed to produce quality financial reporting, it is apparent that quality financial reporting is often an illusion or myth. In practice, as can be seen from a number of accounting scandals and bankruptcies, some companies have published low-quality financial reports and provided misleading information. Quality financial reporting is still a dream of accountants. It seems to be a myth. The reality of financial reporting is different from what people currently believe and the myths and realities of quality financial reporting are summarised below.

***Myth 1: high-quality financial reporting is useful in promoting an efficient capital market.*** Efficiency and competitiveness of capital markets have encouraged companies to provide low-quality financial reporting by being committed to earnings management, creative accounting and accounting frauds (Clarke, et al. 2003; Pijper 1993). Top management can manage earnings by employing a number of accounting techniques and methods both within and beyond generally accepted accounting principles (Jennings 2003).

Bromwich (1992) argues that accounting reports are seen as the only means of publishing information. In the model of decision-making theory (see for example Demski 1980; Marschak and Radner, 1972), it is claimed that individual's past knowledge and experience will be inspired by any information gained over their lifetime (Bromwich 1992). Thus if managers believe that users can be fooled by managing earnings, they will continue to produce low-quality financial reports.

In the case of the HIH collapse, for example, Hon. Justice Owen was disappointed with the accounting systems and procedures adopted by HIH. He noted that (HIH Royal Commission 2003, p. xlvi):

> ...users of HIH accounts may not have understood it at the time, but in 1999 and 2000—the years to which primary attention was given in the inquiry—the financial statements were distorted by questionable entries, heavy reliance on one-off end-of-year transactions, and aggressive accounting practices...including, despite significant losses, continuing to record as an asset in its financial statements the full value of the future income tax benefits.

In addition, in 2002, WorldCom filed the largest bankruptcy in accounting history, revealing that management fraudulently misstated earnings. Arthur Andersen, WorldCom's auditor, failed to notice US$3.85 billion shifting of funds to cover up revenue shortages (Oliver 2004). The Enron case also showed a similar pattern of earnings management. Enron had "aggressive earnings targets and entered into numerous complex transactions to achieve those targets" (Jennings 2003, p. 47).

***Myth 2: high-quality financial reporting provides relevant, reliable and useful information.*** Information contained in financial reports tends to be backward-looking, focusing on historical information and accrued earnings that are not responsive to the current dynamic of the environment. Bromwich (1992) believes that it is almost impossible for the accounting systems of firms to provide all the information required to value the enterprise.

Bromwich (1992) continues to argue that studies of the informativeness of accounting information generally produce a view that accounting information, if it has any information value, will influence share prices and trading volumes on the capital market. However, studies that indicated a high correlation between accounting information and changes in security prices and trading volumes would not automatically determine a value of such information (for further discussion see Lev and Ohlson 1982). Financial statements were not widely read by users nor used as the main source of making a decision (Andersen and Epstein 1995; Bartlett and Chandler 1997; CPA Australia 2002), and were seen sceptically by the investment community and society in general (Hymowitz 2002; Lublin 2002).

***Myth 3: high-quality financial reporting is achieved through conformity with generally accepted accounting principles***. Conformity with generally accepted accounting principles is frequently used by management as a "magical means" of providing minimum information that leads to low-quality financial statements.

The current practice illustrates that in audit reports, an auditor expresses an opinion on the audited financial reports by writing that financial statements are presented fairly in accordance with generally accepted accounting principles. In Australia, for example, AUS 702 "The Audit Report on a General Purpose Financial Report" (p. 352) states that

> …the financial report is presented fairly in accordance with Accounting Standards and other mandatory professional reporting requirements in Australia,….so as to present a view which is consistent with our understanding of the [entity's] financial positions, the results of its operation and its cash flows.

Such statements might stimulate managers to provide minimum information legally required by regulations. Thus, moral responsibility for providing quality financial reporting has been ignored by the managers (Jennings 2005b). The

Enron collapse indicated that the company's personnel were very sophisticated, entered into numerous complex transactions and were often aggressive in restructuring transactions to achieve financial reporting objectives (Jennings 2003).

In addition, changes in investment decision making have forced regulatory bodies to issue complex accounting standards in order to provide information that is perceived to be relevant for such a decision (Bromwich 1992). Nevertheless, the investment decision-making criteria for setting accounting standards are not without debate (Heath 1988; Hines 1991; Tinker 1991).

***Myth 4: high-quality financial reporting is achieved through the involvement of an independent auditor***. Involvement of independent auditors in a company goes beyond auditing functions, which leads to low-quality financial reporting. For example, Arthur Andersen, a well-known accounting firm, let the line between consulting and auditing blur. The collapse of large companies worldwide (HIH insurance, Enron, WorldCom) have sparked lively interest in the amount of consultancy fees that external auditors receive in addition to audit fees[8]. In the Australia environment, HIH insurance paid Andersen A$1.7 million for audit services and A$1.6 million for consultancy services for the 1999–2000 financial year (Pha 2001). As a consequence, it has been argued that the role of external auditors has been subject to the influence of the board of directors of the company (Byrne 1998; Tinker 1991).

[8] For example, General Electric paid KPMG US$24 million for auditing services, but more than three times that amount for consultancy services, and Sprint paid Ernst & Young US$12 million for auditing service, but US$63.8 million for consultancy services (Source: Standford Business School, *Consulting Contract Impair Auditor Objectivity*, accessed from www.newswise.com, 25 August 2001).

In order to obtain a full understanding of the economic condition of the company, auditors must gain access to accounting records and other supporting documents, which are prepared under the supervision of directors. Consequently, for auditors to obtain appropriate access, they must gain the trust and assistance of the directors, which may, in turn, destroy the auditors' independence. Revsine (1997, p. 30) insists that

> auditor's preferences for reporting methods will be influenced by the degree of client harmony elicited by various alternatives...Sometimes harmony requires "slack" in the system as a desirable safety valve, while under other circumstances rigidly specified rules provide a convenient shield for the auditor to hide behind.

The lack of independence has made investors doubt the reliability of the auditor's opinion on the audited financial statements. Byrne (1998) showed evidence that institutional investors appreciate the work of auditors, but they also look for other ways of validating information. This evidence suggests that the works of independent auditors are questionable.

The HIH collapse in Australia provides convincing evidence of the inability of the auditor, Arthur Andersen, to stand properly on their own independence, both in fact and in appearance in undertaking the HIH audit. Andersen issued an unqualified auditor's report five months before the collapse of HIH indicating A$940 million net assets—assets of A$8.32 billion against liabilities of A$7.38 billion (Donnan and Peel 2001). This has been of particular concern to the public because an unqualified audit report was generally perceived as giving HIH a clean bill of health (Clarke, et al. 2003; Pha 2001).

Pha (2001) described the relationship between HIH and Arthur Andersen as "cosy", a far cry from the requirement of independence. Hon. Justice Owen also noticed that the independence of HIH's auditors, Arthur Andersen was compromised in several ways (HIH Royal Commission 2003):

1. Andersen derived significant fees from non-audit work that gave rise to a conflict of interest with the audit obligation.
2. The HIH board of directors consisted of three former Andersen partners.
3. One Andersen partner was the chair of the HIH board of directors and continued receiving fees under a consultancy contract.
4. A partner was removed from the audit team after meeting with non-executive directors in the absence of management.

The Enron collapse also showed a similar relationship between Andersen and Enron. In fact, "[w]hile the Enron/Andersen relationship was extreme, its individual components provide indications of how a relationship can become so muddled that auditor independence is sacrificed" (Jennings 2003, p. 47). The above evidence shows that auditors were not independence and this can lead to low-quality financial reporting.

***Myth 5: high-quality financial reporting is achieved through corporate governance mechanisms***. Even so, the effectiveness of such mechanisms depends on the power held by chief executive officers and the board of directors. Most actors who are involved in corporate governance mechanisms and play a supervisory role tend to be powerless. They exist only as "accessories" of the company. The presence of the board of directors in companies is only needed to meet legal requirements. Indeed, in many instances, the role of the board of directors is to act as a "rubber stamp" (Pearce and Zahra 1991, p. 457) to support management decisions, as they lack of expertise in evaluating and overseeing how decisions are made. In a decision-making process, the board merely provides agreement on what the chief executive officer (CEO) decides or recommends. Accordingly, the lack of a knowledge of financial reporting practice on the part of members of the board of directors could lead to low-quality financial reporting.

Attempts to reform corporate governance practices and to improve financial reporting practice have been conducted in a number of countries. For example, following a series of high-profile scandals, the US *Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act* (SOX) was passed in 2002 by the US Congress. This was seen as one of the most significant legislative reform packages in the US (Wolk, et al. 2004). Designed to improve investor confidence by preventing corporate scandals, SOX makes CEOs and chief financial officers (CFOs) of publicly listed companies legally accountable for the veracity and integrity of their financial statements (Goodman 2004). Furthermore, SOX more clearly defines auditor independence, audit committee roles in corporate governance mechanisms, record retention requirements and penalties for noncompliance (Miller and Pashkoff 2002).

A similar reform was also conducted in Australia. On 1 July 2004, a series of legislative amendments, the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*, or CLERP 9, was introduced by the Federal government to revise corporate regulations in Australia. CLERP 9 reforms are intended to ensure that business regulation in Australia is "consistent with promoting a strong and vibrant economy and provides a framework which assists business in adapting to change" (McConvill 2004, p. 1).

CLERP 9 amendments are based on the Federal Government's response to the Ramsay Report, *Independence of Australia Company Auditors* and the recommendation of the HIH Royal Commission following the collapse of HIH insurance and One.Tel (McConvill 2004). Most of the provisions of CLERP 9, came into effect and were fully implemented on 1 January 2005. CLERP 9 amendments change the Australian Securities and Investments Commission's (ASIC) framing legislation (the *Australian Securities and Investments Commission Act 2001* and the *Corporation Act* 2001)[9]. It is important to note that some of the requirements of CLERP apparently mirror the requirements of SOX, such as the CEO and CFO declaration in regard to the financial reports (Brown and Tarca 2005). However, CLERP 9 reforms are perceived as less stringent than SOX (Oldfield 2004).

SOX and CLERP 9 should improve the quality of financial statements by having company officers formally acknowledge their responsibility for financial statements and by increasing auditor independence. Although SOX and CLERP 9 are helpful in improving financial reporting practice, much more must be done. This is because "the regulatory reform structures are fundamentally weak in strategic areas, for example, the nature of legislation and accounting standards, enforcement and overall administration" (Cooper and Deo 2005, p. 156). ASIC also acknowledges that enforcement actions "will only ever catch a relatively small number of offenders, often after the horse has bolted" (ASIC 2003, p. 5). Moreover, as Fred Hassan, the chairman of the Board and CEO of Schering-

[9] See McConvill (2004) for a discussion of the CLERP 9 reforms.

Ploogh said, "business integrity means living up to the intent, not just the letter of the laws and regulations wherever we operate" (Building Trust 2004, p. 28, cited by Goodman 2004). Thus, as Jennings (2005b, p. 46) concludes

> [w]hen all the reforms have been adopted and all the corporate procedures are put into place for compliance, we remain dependent upon ethically strong and vibrant officers and board members to hold firms, investigate on hunches, and hire on the basis of integrity.

The above views imply that ethical culture and personal integrity of actors in conducting and supervising business will determine quality of financial reporting.

***Myth 6: high-quality financial reporting is achieved by mechanisms of regulation because regulation is intended to protect public interests***. However, regulations are weak in enforcement and permissive in regard to flexibilities in accounting choices, which leads to low-quality financial reporting (Jennings 2003). Recent corporate failures such as HIH Insurance and One.Tel in Australia, and WorldCom and Enron in the US provide evidence that regulation is weak. One.Tel was liquidated in May 2001 with estimated debts of A$600 million. Creative accounting by One.Tel in capitalising expenses had attracted attention of the Australian Securities and Investments Commission (ASIC), and its insistence that accounting practices be changed led in August 2000 to the company declaring $245 million of costs that would otherwise be hidden (Barry 2002).

In addition, the collapse of the insurance company HIH in March 2001 led to strong criticisms to the roles of regulators. In this case, Hon. Justice Owen claimed that the regulators had been "asleep at the wheel" (HIH Royal Commission 2003). Hon. Justice Owen observed that the Australian Prudential

Regulation Authority (APRA) had several deficiencies, including staffing shortfalls, outdated legislation and an inadequate supervisory methodology (HIH Royal Commission 2003).

Even though corporate legislation reforms have been conducted, there are always certain ways for dishonest players to find loopholes in laws. Today's accounting frauds, auditing irregularities and corporate scandals are not because of a lack of regulations. Instead, it is irresponsible and dishonest individuals who have produced such problems (Jennings 2003; 2004a; 2004b; 2005a; 2005b). Moreover, regulations issued by authoritative bodies only serve to underplay the significance of their reputations as an asset in the market. They make rules that could well be circumvented by corrupt alternatives, which are inevitable when the regulatory bodies monitor accounting practices.

A study by Grabosky and Braithwaite (1986) reveals a number of examples of regulatory deficiencies. In the early 1980s, Grabosky and Braithwaite (1986) characterised Australian regulators as being of "manners gentle", that regulators were slow to use formal enforcement powers, and resorted to persuasion and negotiation for a long time before resorting to either administrative or judicial proceedings in the regulatory process. By interviewing the executives of 111 Commonwealth, state, and local government agencies, Grabosky and Braithwaite (1986) concluded that overall, regulatory agencies in Australia indicated fairly low levels of punitive enforcement. Even those agencies that followed the rulebook-oriented approach did not employ their extensive powers to their fullest extent[10]. Grabosky and Braithwaite (1986) described these enforcers as token or modest, depending on the strength of imposed sanctions. They viewed this condition as a result of regulatory capture. Their study (1986, p. 203) indicated that “when regulatory agencies have close relations with a small number of regulated companies or regulated industries, they are less punitive, and when regulatory agencies confront big business, they are less punitive”.

Considering the above problems of financial reporting practice, a number of studies have been carried out to determine the factors influencing quality financial reporting. The following section will discuss empirical studies of financial reporting.

## 2.3 EMPIRICAL STUDIES OF FINANCIAL REPORTING

Recent instances of accounting fraud and irregularities have led to much debate and raised concerns from researchers, practitioners and politicians. For example, a number of such frauds and irregularities led to investors and other users of financial reports raising questions about the quality and integrity of the financial reporting process, and the usefulness of financial reports in helping investors make economic decisions (Dunn 2003; Hymowitz 2002; Lublin 2002). A number of empirical studies have been conducted to address complicated issues related to financial reporting practice. The following sections discuss the focus of empirical studies of financial reporting, problems of empirical studies and a dominant theory underlying such empirical studies.

[10] Grabosky & Braithwaite (1986) said that the rulebook-oriented type of regulation focuses on applying regulatory forces at arm’s length to maintain control of industry or individuals.

### 2.3.1 Focus of Empirical Studies

The first issue that leads to the need for research of financial reporting practice is in regard to the usefulness of financial reports. Many survey findings show that annual financial reports are not widely read by users nor used as the main source of making a decision (Anderson 1979; Anderson and Epstein 1995; Bartlett and Chandler 1997). Most recently, a survey conducted by the CPA Australia (2002) indicated that only 43 per cent of respondents were quite confident in financial reporting, while 30 per cent did not rely on financial reporting. The level of confidence had decreased compared to the previous 12 to 18 months.

The earlier study by Bartlett and Chandler (1997) also demonstrated that annual reports were not widely read, even though there was an increase in the voluntary narrative section of them. Besides studies of the usefulness of financial reports, other studies have been directed towards investigating how to enhance the quality of financial reporting (for example, Cohen, et al. 2004; Jonas and Blanchot 2000), and how information provided by financial reports affects market efficiency and individual behaviours (Amir and Lev 1996; Healy et al*.* 1999; Lev and Ohlson 1982; Lev and Zarowin 1999).

Studies of financial reporting, then, have proceeded in several directions. Early on, as Mathews and Perera (1993), Ryan, et al. (2002) and Wolk, et al. (2004) noted, studies on financial reporting were directed at attempts to derive accounting principles or concepts underlying financial reporting focused on the decision-usefulness approach (for example Gilman 1939; Grady 1965; Paton

1922; Paton and Littleton, 1940). Within this approach, empirical research is stimulated by two types of studies: behavioural research and market-based accounting research (Ryan, et al. 2002). Behavioural research, for example, which usually uses surveys, field studies and experiment methods, is focused on information usefulness for investors' decisions, and information quality perceived by users (for example, Anderson 1979; Anderson and Epstein 1995; Chenhall and Juchau 1977; Lee and Tweedie 1975a; 1975b; 1976). Studies within market-based accounting research frameworks analyse the relationship between accounting numbers and disclosure and equity market value (for example, Amir and Lev 1996; Botosan 1997; Francis and Schipper 1999; Healy 1985; Healy, et al. 1999; Lev and Ohlson 1982; Lev and Zarowin 1999).

Studies within a decision-usefulness paradigm are mainly focused on how information is produced and utilised for making decisions under economic consideration, such as firms' economic characteristics and users' behaviour. Brown (1994) argues that studies of financial reporting emphasising information perspectives have been replicated for firms with different fiscal years, in different countries, and at different times, and have been cast in the mould of a traditional experiment: hypothesis, data collection, data analysis and conclusion.

Studies of financial reporting, then, have been dominated by the positive accounting research paradigm framework, which is based on agency theory. Within this framework it is assumed that the agent is perceived as the rational maximising economic agent, and that general equilibrium is achieved by market forces (Watts and Zimmerman 1986). In addition, the positive paradigm addresses particular problems to be analysed using mathematical and statistical techniques (Ryan, et al. 2002).

According to proponents of positive accounting research, scientific research starts by making empirical observations with the aim of discovering general laws in the studied field of research (Abdel-Khalik and Ajinkya 1979; Watts and Zimmerman 1986). Empirical research is aimed at explaining and predicting how self-interested individuals behave when facing economic consequences of particular accounting issues. In general, positive accounting research is concerned with managers' choices in regard to financial information, such as accounting policies, earnings management and corporate disclosure (Holthausen 1990; Watts and Zimmerman 1986).

Studies within a positive paradigm mostly frame accounting choices and financial reporting as discretionary choices of management based on economic and opportunistic behaviour. This research has focused on the three main economic influences in explanation of managerial incentives for selecting accounting policies: management compensation, debt covenant and political cost variables (Watts and Zimmerman 1986). These studies tend to view financial reporting as a static process involving routine accounting techniques and rational behaviours.

Financial reporting issues have also raised concerns about the roles of corporate governance mechanisms, auditors and regulators in monitoring managers' behaviour (Cohen, et al. 2004; Bartley 2002; Browning 2002). In an agency relationship, managers are assumed to use discretionary margins to maximise their interest to the detriment of the interests of the principal. This is called residual losses (Berle and Means 1975; Jensen and Meckling 1976). Such losses are to some extent avoided by means of control mechanisms, such as accounting regulation and audit (Watts 1977) and corporate governance mechanisms (Fama and Jensen, 1983; Jensen 1986; Jensen and Meckling, 1976; Weir, et al. 2002).

Consequently, studies within a framework of agency theory concerning the association between corporate governance mechanisms and financial performance and financial reporting have emerged during the last few years. Williamson (1985), in his analysis of transaction costs, discusses a framework that links quality of financial reporting, in terms of disclosure quality, to corporate governance. Moreover, Forker (1992) argues that adoption of internal control devices, such as audit committees, and independent boards of directors, would enhance the monitoring of the quality of disclosure and would also reduce the likelihood of managers withholding information. Hence, corporate governance mechanisms should enable corporations to improve firm performance and quality of financial reporting[11].

However, studies of financial reporting within the positive paradigm suffer from a number of problems, such as lack of convincing evidence, a problem with research objectives, and confusing generalisation. The following section will discuss such problems.

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[11] Cohen, et al. (2004) provide a comprehensive review on the relationship between corporate governance mechanisms and financial reporting quality. Their study discussed weaknesses of the previous studies and suggested a number of research approaches, including the use of interviews to study financial reporting.

### 2.3.2 Problems of Empirical Research

#### 2.3.2.1 Lack of Convincing Evidence

Even though mainstream accounting research has dominated current accounting research, this has resulted in disappointing findings. Indeed, the empirical studies do not provide conclusive evidence of the relation between corporate governance mechanisms, economic performance and the quality of financial reporting. For example, findings of empirical studies on the association between boards of directors and performance showed contradictory evidence (Agrawal and Knoeber 1996; Bhagat and Black 1998; Chaganti, et al. 1985; Klein 2002; Lanser 1969; Pfeffer 1972; Schmidt 1974; Vance 1955; 1968; 1978; Wayne 1983; Weir and Laing 1999; Yermack 1996). Regarding studies on the association between corporate governance and financial reporting, findings also indicated mixed results (Beasley 1996; Beasley et al. 2000; Chen and Jaggi 2000; Cohen, et al. 2004; Dunn 2003; 2004; Forker 1992; Goodwin and Seow 2002). Although the studies show different results, they did not provide convincing explanations for such diverse findings.

A number of explanations for these mixed findings can be advanced. One of them is the use of confusing proxies to operationalise explanatory variables in statistical models. The earlier studies mostly measured corporate governance mechanisms from the perspective of governance structures using proxies (such as the presence of independent boards of directors and audit committees, the proportion of their independent members and the size of the board or committee). Studies of financial reporting, for example, disclosure, are also based on the use of proxies, such as company size and ownership structure. Different measures or proxies could give rise to different results, and the best and most objective ways of adopting such proxies are never available. It depends on the researcher making the subjective selection. Watts and Zimmerman (1986) have also recognised that the application of vague proxies, different sample sizes and incorrectly specified functional models have produced inconclusive and mixed results. The differences in research findings could also arise because of the differences in the time period of the studies or the cultural environment of countries (Adams and Kuasirikun 2000; Chen and Jaggi 2000; Hofstede 1987; Perera 1989). Different characteristics of organisations, such as organisational culture, might also result in different findings (Geriesh 2003; Loebbecke, et al. 1989; Merchant 1987; Rezaee 2002).

It is believed that the presence of structure of corporate governance mechanisms does not guarantee a reduction in the likelihood of managers to withholding information (Fogarty and Kalbers 1998; Kalbers and Fogarty 1993; Tricker 1994a). The effectiveness of control mechanism depends on values, norms and beliefs accepted in organisations (Oliver 2004, Jennings 2004a; 2004b; 2005a) and the involvement of actors in the control structures in monitoring managers (Cohen, et al. 2004; Jennings 2005b). Problems with diverse research findings can be related to the objectives of positive accounting research ("to explain and predict" accounting phenomena) and the final aim of discovering general laws (generalisation) in the studied field of research (Abdel-Khalik and Ajinkya 1979; Watts and Zimmerman 1986). Unfortunately, positive accounting research suffers from weaknesses in regard to the research objectives and generalisation as discussed below.

#### 2.3.2.2 Problems with Research Objectives

The second problem of positive accounting research is related to the objectives of the research. The objective of positive accounting theory is to "explain and predict" accounting practice and to derive general laws (generalisation) in the studied field of research. However, currently, such research only explains why certain accounting practices take place by analysing observable variables. Positive accounting theory has been unable to predict unobserved phenomena. It might be true, as Godfrey, et al. (1994, p. 204) claim, that

> prediction of accounting practice means that the theory predicts unobserved phenomena. Unobserved phenomena are not necessarily future phenomena; they include phenomena that have occurred, but on which systematic evidence has not been collected. For example, positive theory research seeks to obtain empirical evidence about the attribute of firms that continue to use the same accounting techniques from year to year versus the attributes of firms which continually switch accounting techniques.

However, the *Oxford English Dictionary* (1992) defines prediction as foretelling an event. Using this simple definition, positive accounting research should be able to predict what is going to occur when certain events come about.

Unfortunately, such research has paid attention to individual behaviour in relation to certain accounting practices. The problem is whether such behaviours can be predicted using a statistical model, such as a regression model. It is hard to believe that human behaviours can be determined by using certain proxies. Studies of financial reporting based on explanation have tended to "ignore the effects of social context" (Mezias 1990, p. 451). In regard to explanation and prediction, it is interesting to note a view by Aligica (2003, p. 1028) that

> in the case of *explanation*, the model [positive model], while adequate for many important types of scientific explanations is not at all applicable to all scientific domains. It is definitely not a complete account or explanation...Imposing prediction as a fundamental concept and criteria for explanation the positivist epistemological model set standards that many disciplines could never achieve by their very nature.

Furthermore, in Hempel's (1942; 1963) thesis of the logical symmetry of scientific explanation and prediction, it is claimed that explaining and predicting events are logically and methodologically analogous processes. Hempel (1963, p. 38) said that

> [a]n explanation...is not complete unless it might as well have functioned as a prediction; if the initial events can be derived from the initial condition and universal hypotheses stated in the explanation, then it might as well have been predicted, before it actually happened, on the basis of a knowledge of the initial conditions and general laws.

Thus, to derive convincing findings, a regression model employed in studies of financial reporting should be able to explain and predict the unobserved phenomena. However, it is questionable whether positive accounting research is able to make predictions regarding accounting practice. To make an accurate prediction, the predictive power ($R^2$) of the hypothesised model should be high. Unfortunately, as mentioned by Godfrey, et al. (1994), regression models indicate that the predictive power of the model is low[12]. This means that independent variables (for example, the number of the board of directors and company size),

[12] See for example research findings by Beasley 1996; Beasley, et al. 2000; Chen and Jaggi 2000; Cohen, et al. 2004; Dunn 2003; 2004; Forker 1992; Goodwin and Seow 2002.

which are used in the model are unable to predict variability in the dependent variable (for example, quality financial reporting). In the model it is impossible to conclude that if the independent variable (for example, the number of the board of directors) increases or decreases, then quality financial reporting will increase or decrease proportionally. Studies of financial reporting have only been able to explain the relationship between variables by confirming a set of research hypotheses. Unfortunately, as discussed in the previous section, the studies have produced diverse findings, even though they use similar variables in their statistical models.

In addition, because positivists employ a statistical approach in making general laws in the studied field of research, such approach has attracted a number of critiques. Lukka and Kasanen (1995) argue that in employing a certain statistical analysis, researchers are usually guided by statistical reasoning that is based on statistical theory and positive accounting theory. However, statistical theory and positive accounting theory, which are performed to help positivist analyses of human behaviour, rely on certain assumptions that might not fit with the reality of human behaviour (Band 1992; Brennan 1995; Donaldson 1990; Perrow 1986). Regrettably, most empirical researchers do not really understand the fundamental and inherent limitation of the theories. Lukka and Kasanen (1995, p. 79–80) show the misuse of statistics in accounting research as follows:

> (1) Statistical analysis is performed inadequately or left entirely undone, even though it would have been suited to the overall approach of the study. The credibility and generalisability of the results suffer as the role of randomness has not been related to the observed phenomena.

(2) Statistics is used as an “amulet”, an exterior symbol of science, and the theoretical sophistication of the statistical method employed substitutes for the real economic analysis of the hypotheses and the interpretations. The credibility and generalisability of the results suffer as the underlying economic and accounting assumptions are unrealistic, or the whole question is irrelevant.

Thus, the problem is not with statistical method itself but with the use of statistical methods or mathematic formulae in the studies of financial reporting. Wigner (1960) calls this “the unreasonable effectiveness of mathematics in the natural science”, meaning that it is difficult to understand why so much of the complexity of the world can be described by so relatively simple mathematical formulae.

Similar to the above view, Bricker and Chandar (1998) remark that empirical research has been narrowly focused, and has been mainly based on analytical or statistical approaches employing large standardised-databases. Such exclusive reliance on a narrow basis is inappropriate in advance knowledge in an interdisciplinary subject such as accounting, which exists within a complex interplay of political, social and economic settings (Bricker and Chandar 1998).

The objectives of positive accounting research is more problematic when the objectives are related to the final aim of empirical research, which is directed towards making generalisation of research findings. The process by which generalisation is generated from research findings looks confusing. The following section will discuss a problem with generalisation in empirical research.

#### 2.3.2.3 Confusing Generalisation

In relation to the empirical research findings, it can be argued that findings of positive accounting research of financial reporting have led to confusing generalisation. An interesting example of generalisation problems can be seen from a case study conducted by Bamber*,* et al. (2000), which focused on an article that is covered in most accounting doctoral programs: Beaver's 1968 article regarding the information content of annual earnings announcements (Beaver 1968). The findings from Bamber, et al. (2000, p. 103) show that

> ...the community of accounting research has not fully appreciated the sensitivity of research conclusions to (necessarily) subjective research design choices, and that this failure has led to the subsequent over generalization of early evidence.

Furthermore, Bamber, et al. (2000, p. 104)) argue that while accounting scholars "think we understand" the consequence of research design choice, the scholars have collectively failed to apply this understanding in practice, and such failure postpones the acquisition of knowledge.

In addition, positivists tend to confirm their claims by publishing findings that support their hypotheses and ignore other findings that reject them. This, for example, can be inferred from the claims by Godfrey*,* et al. (1994, p. 263):

> in concentrating on criticising Watts and Zimmerman's original works, critics have largely ignored the increasing body of evidence which supports the fundamental hypotheses of positive accounting theory. They also fail to provide a competing theory which has superior explanatory or predictive power.

Such a statement signifies that positivists tend to recognise research findings that only support hypotheses of positive accounting research and neglect other alternative approaches. Bamber*,* et al*.* (2000) assert that because of limited publication of replication, accounting researchers have little alternative but to generalise from a small number of published studies. Indeed, as Greenwald (1975) argues, the majority of published research rejects the null hypotheses. Prejudice against the null hypotheses delays the acquisition of knowledge (Greenwald 1975).

Moreover, Bamber, et al. (2000) highlight that a bias in empirical research might occur because of monopoly by collective academic communities. For Bamber, et al. (2000, p. 124), “normal science is characterised by a tendency to overlook inconvenient evidence that is inconsistent with prevailing beliefs”. Bamber, et al. (2000) shared a view with Kuhn (1970, p. 35) that research results that do not turn out as expected are viewed as “just a research failure, one which reflects not on nature but on the scientist”.

To sum up, empirical studies of financial reporting may be flawed because of lack of convincing evidence. This problem could be related to the objectives of positive accounting research that focuses on explanation and prediction with the final aim of deriving general laws (generalisation). Furthermore, weaknesses of empirical studies could be related to the use of a dominant theory, agency theory, which underlies empirical research—especially studies of financial reporting. However, agency theory ignores the environmental context in which financial reporting practice takes place. The following section will discuss agency theory and its weaknesses.

### 2.3.3 The Dominance by a Single Theory

The use of statistical methods in accounting research is primarily justified by agency theory. Agency theory provides a formal framework for studying agency relationships, and has been seen as a powerful research paradigm in describing and explaining contractual relationships between a principal and agent (Chi 1989).

Agency theory is popular amongst accounting scholars because the demand and uses of information are derived endogenously in the agency model, rather than assumed (Chi 1989). For example, Baiman (1982) focuses his empirical issues on two uses of information in an agency relationship: belief revision and performance evaluation. Meanwhile, Demski and Kreps (1982) classify such uses as decision-facilitating and decision-influencing roles of information.

Furthermore, Bohren (1998, p. 753) claimed that the reason for the popular use of agency theory is that "popular theories are probably more easily internalised and put to practical use than less popular ones by professors, students, and managers alike". Bohren (1998) also posited that behavioural models are not value neutral, and theories may have social power. Indeed, when Tinker and Puxty (1995, p. 4), were discussing "policing accounting knowledge", they argued that

> ...the social context overshadows academic debate and preconditions its outcomes in fundamental ways, usually "behind the backs" of the protagonists...theorising may be conditioned and directed by forces that, as of necessity, escape the attention of the theorist.

In addition, because theoretical systems cannot be separated from a broader social system, the rise and fall of theories depend not simply on epistemic virtue, but in the mutual adaptation of ideological, social, cultural, political and economic conditions (Tinker, et al. 1982).

Albeit agency theory has been widely used as a dominant theory in accounting research, it suffers from some weaknesses. For example, agency theory is said to be too abstract (Arrow 1985; Bricker and Chandar 2000; 1998;

Doucouliagos 1994; Kotowitz 1987; Perrow 1986; Salanie 2002), to be based on narrow assumptions—that individuals are self-interest maximisers (Akerlof 1983; Band 1992; Becker 1976; Brennan 1994; Donaldson 1990; Etzioni 1975; Harsanyi 1976; Noreen 1988; Perrow 1986; Sen 1986), that it ignores environmental and social contexts (Arrow 1985; 1971; Mezias 1990; Tricker 1994b), and that it cannot be methodologically falsified (Walker 1989; Bohren 1998).

Such weaknesses insinuate that studies of financial reporting should not be based on a single theory. Regardless of the popularity of agency theory, Eisenhardt (1989) suggests that "agency theory presents a partial view of the world that, although it is valid, also ignores a good bit of the complexity of organisations" (p. 71), and "organisational researchers should look beyond the economic literature" (p. 72).

It is obvious that organisational activities do not take place in a vacuum. They operate in an arena characterised by a specific social, political, and cultural environment. Thus, organisations trying to survive in the arena should be able to see their position in a community and understand the norms and values shared by members of the community. Selznick (1957, p. 136) points out that

> truly accepted values must infuse the organisation at many levels, affecting the perspective and attitudes of personnel, the relative importance of staff activities, the distribution of authority, relations with outside groups, and many other matters. Thus if a large corporation asserts the wish to change its role in the community from a narrow emphasis on profit-making to a large social responsibility (even though the ultimate goal remains some combination of survival and profit-making ability), it must explore the implications of such a change for decision making in a wide variety of organisational activities.

The above view implies that in constructing financial reporting practice, organisational actors should consider ethical issues. McCoy (1985) discussed the ethical implication of business behaviour. He (1985, p. 87) sees ethics as an important part of business conduct and argues that

> dealing with values requires continual monitoring of the surrounding environment, weighing alternative courses of action, balancing and (when possible) integrating conflicting responsibilities, setting priorities among competing goals, and establishing criteria for defining and evaluating performance. Along with this goes learning ways to bring this ethical reflection directly and fully into the processes by which policy is made, implemented, and evaluated. Increasingly, skills in dealing with values as integral components of performance and policy-making are being recognised as central for effective management in a society and a world undergoing rapid change.

The ways that companies are doing business in regard to ethical conduct and how they exercise their position in society is determined by their relationships to the stakeholders' community and the culture of the organisation. Kotter and Heskett (1992) discuss the importance of culture and showed how culture can lead to either good or bad performance and can decrease the ability of organisations to adapt to a changing environment. As accounting can be viewed from different paradigms, studies of financial reporting should consider its cultural and environmental context.

## 2.4 FINANCIAL REPORTING STUDY: A CULTURAL PERSPECTIVE

It is recognised that the current research in accounting and corporate governance is alert to the fact that actors' behaviour is modified by procedures, rules, incentives and other economic factors. The examinations to date have all but ignored the role of institutions, power and culture play in financial reporting practice. Financial reporting practice does not exist in a vacuum, but operates in an environment characterised by a specific culture. The call for studying accounting within its environmental context has been suggested by many scholars (Adams 2002; Adams 1997; Gordon and Miller 1976; Gray 1992; Gray 1988; Hopwood 1983; Miller 1994; Neimark and Tinker 1986). Such a call is mainly stimulated by a belief that accounting is a socially constructed reality (Hines 1988; Morgan 1988; Munro 1998).

### 2.4.1 Financial Reporting as a Socially Constructed Reality

As a socially constructed reality, accounting, including financial reporting practice, is an institution that is socially constructed by individuals both within an organisation and outside it. Gray (1988) contends that how legislation and regulations support openness (or secrecy) and uniformity (or flexibility) in financial reporting are important institutional traits affecting disclosure decisions in companies. Adam (1997, p. 731) also argues that disclosure

> is a complex phenomenon which is influenced both by organisational antecedents, such as company culture and tradition, and environmental condition, such as industry norms and market competition.

The above views imply that financial reporting practice cannot be studied separately from the institutional, political, social and cultural environment in which such practice takes place. This is because, as Morgan (1998, p. 223) argues,

> organisations and the fields within which they compete, cooperate and are regulated are governed by particular rules of action...[which] can be conceived of as a way in which social values and ethical choices are institutionalised...

Miller (1994) also shares a similar view. He (1994, p. 1) asserts that "accounting has come to be regarded as a social and institutional practice, one that is intrinsic to, and constitutive of social relations..." As a part of accounting activities, financial reporting can be constructed as a rhetorical story of a company's activity to gain legitimacy. This is because "accounting numbers...are *socially constructed*" (Munro 1998, p. 201; original emphasis). Munro (1998, p. 202) continues to argue that "an appreciation of accounting being *socially constructing* as well as socially constructed has led to accounting practice...being *invested* with values"(original emphasis). As a socially constructed reality and from a cultural point of view, financial reporting practice should not be studied within the framework of the positive paradigm, which assumes the presence of a detachable, objective reality that can be observed in a value-free manner (Mouck 1992).

### 2.4.2 Culture and Financial Reporting Study

Following a view that accounting is a socially constructed reality, financial reporting practice cannot be separated from its cultural context. Indeed, culture plays important roles in constructing social structure and institutions (Hofstede 1984; Schein 2004; Taylor 2004; Velayutham and Perera 1996; Zucker 1988). Scott (1995) also believes that culture is a carrier of cognitive, normative and regulative rules into organisations. Consequently, culture influences the financial reporting practices of a company (Adams 2002; Adams and Kuasirikun 2000; Geriesh 2003; Hofstede 1987; Jaggi 1975; Perera 1989; Thomas 1989).

By definition, culture should be seen from a different perspective. The definition of culture by Hofstede (1984) is one mostly cited in accounting literature. For Hofstede (1984, p. 21), culture is

> the collective programming of the mind which distinguishes the members of one human group from another...Culture in this sense, includes systems of values; and values are among the building block of culture.

Within such a view, Hofstede (1984, p. 5) claims that culture is "learned, not inherited. It derives from one's social environment, not from one's genes". This implies that culture is a set of shared ideas, values and beliefs among individuals who live in the same environment. Elsewhere, Hofstede (1987, p. 1) remarks that

> being a group or institution or society together poses certain basic questions the world over, and a culture is the particular set of shared answers to those questions in the minds of a particular category of people.

Consistent with a view that a reality is socially constructed (Berger and Luckmann 1984), culture is also "a socially constructed mechanism" (Gelfand and Christakopoulou 1999, p. 251). Thus, symbols, meanings and values can be adopted and manipulated by individuals to create a reality of an organisation or society (Hofstede 1997; Schein 2004) and to influence its members to behave according to beliefs, values and norms accepted in the organisation. In addition, Maclagan (1998, p. 130) maintained that "plainly one cannot treat organisations in isolation, unaffected by wider values or public pressures. People import societal values into the organisation". Within an organisational context, organisational culture is an example of how values, symbols and meanings are shared by individuals to create a similar pattern of behaviour and thought. The view expressed in Smircich's (1983) work is that, within the organisational milieu, everything contributes to and is merely an expression of culture.

There is no standard definition of organisational culture, but as Hofstede (1997, pp.178–179) maintained, most people who write about it would probably agree that "organisational culture" is:

1. *holistic* referring to a whole which is more than the sum of its parts
2. *historically* determined reflecting the history of the organisation
3. *related to the things anthropologists study* like rituals and symbols
4. *socially constructed* created and preserved by the group of people who together form the organisation
5. *soft*
6. *difficult to change.*

Accordingly, Taylor (2004, p. 3) opines that

> culture is the result of messages that are received about what is really valued. People align their behaviour to these messages in order to fit in. Changing a culture requires a systematic and planned change to these messages, whose sources are behaviours, symbols and systems.

Following such a view, organisational culture is perceived as "the personality of the organisation; the glue or invisible mortar that holds the entity together" (Barker and Coy 2004, p. viii). Organisational culture "flows from an action because relationships among individuals within an organisation are constructed through a social, rather than entirely policy-driven process" (Fine 1984, p. 234). The reason for this is that when people join an organisation, "they bring their habitus—and their relation to the broader social order—with them...In completing organisational rules, people act on the basis not only of organisational rules, but also of the habitus" (Hallett 2003, p. 130).

As a socially constructed mechanism, organisational culture can be built and managed by individuals in an organisation through a process of learning. Schein (1995, pp.225–226) argues that the basic process of embedding and transmitting a cultural element is a “teaching process” through the use of a number of mechanisms, such as

> formal statements of organisational philosophy, charters, creeds, material used for recruitments and selection, and socialisation... explicit reward and status system and promotion criteria; stories, legends, myths, and parables about the key people and events...

Consequently, as Schein (1995, p. 225) suggests, the process of culture formation involves the following steps:

(1) a single person (founder) has an idea for new enterprise
(2) a founding group is created on the basis of initial consensus that the idea is a good one, workable and worth running some risks for
(3) the founding group begins to act in concert to create the organisation by raising funds, obtaining patents, incorporating, and so forth
(4) others are brought into the group according to what the founder or founding group considers necessary, and the group begins to function, developing its own history.

Within the process, leadership plays important roles in shaping the culture of an organisation. Simpson (2004, p. 117) contends that leadership can be regarded as “a process of symbolic management, where the leader manipulates symbols that are meaningful to followers and that make them feel good about themselves”. Schein (2004, p. 225) also argues that “culture is created by shared experience, but it is the leader who initiates this process by imposing his or her beliefs, values, and assumptions at the outset”.

It should be noted that the way to discuss organisational culture is to talk about ethics (Pastin 1982). Referring to Smircich’s (1983, p. 353) view that "culture is in large part the language, symbols, myths, stories, and rituals", the way to build strong organisational culture is to change organisational discourses into ethically acceptable ones in an organisation. The reason is that "when individuals recognise and make ethical values a part of their value system, this should have a normative significance for the individual's behaviour and actions" (Marnburg 2000, p. 200).

In relation to financial reporting practice, organisational culture and leadership have a role in shaping a culture of transparency. Oliver (2004, p. 31) suggests that to be a truly transparent organisation, four key elements are required:

1. A culture dedicated to openness and a commitment to transparency from an organisation's most senior leadership
2. Programs and processes that encourage and ensure openness at every level, that reward transparency and mete out quick and decisive punishment for opacity, obfuscation, and fraud
3. Well-trained workers, managers, and administrators at all levels of the organisation with the wisdom, integrity, confidence, and security to do and say what is right and to recognise and act when the organisation or individuals are not doing things that should be done
4. Established means of proactive communication to the organisation's important stakeholders.

In addition, as a language of business, Hofstede (1987, p. 3) believes that

> from a cultural point of view, accounting systems in organisations are best understood as uncertainty-reducing rituals, fulfilling a cultural need for certainty, simplicity, and truth in a confusing world, regardless of whether this truth has any objective base.

Annual reports can be used to build a symbol, "an image of the corporation that ingratiates it with its stakeholders" (Stanton, et al. 2004), so as to gain approval by conveying conformity to the normative rules of their institutional environment (Dowling and Pfeffer 1975). By self-promotion, acclaiming the corporation's roles, including that of being socially responsible, corporations assert their appreciation for institutional norms and values (Allen and Caillouet 1994). Coy and Pratt (1998) also remark that financial reporting has an important role in communicating and shaping the reality of an organisation in the public mind.

The above views insinuate that organisational culture and accounting practice can be constructed to drive organisational members to commit to quality financial reporting practice. It is apparent that an ethical culture and behaviour can lead to ethical financial reporting practice. A study of financial reporting should consider its cultural and environmental context[13]. Perera (1989) argues that accounting is a socio-technical activity involving people, technologies and a relationship of both. As people are affected by culture, such a relationship brings accounting practices under the influence of culture. As culture consists of normative postulates or values, such values will determine systematic choices of society in explaining social phenomena. Accounting systems, as social institutions, should reflect such postulates (Violet 1983).

Jaggi (1975) also remarked that the value orientation of managers greatly influences them in making financial disclosures, and that value orientation of individuals in a society to a large extent is affected by the social environment of the society. This is shared by Soeters and Screuder (1988), who opine that

[13] Chanchanni & MacGregor (1999) provide an interesting discussion on a synthesis of cultural studies in accounting. Albeit such a discussion focused on a macro perspective (a country level), their views imply that studies of financial reporting within its cultural context are attainable in an organisational setting.

national and organisational culture in a certain country significantly influence the implementation of accounting systems in the country. Taylor, et al. (1986) argues that accounting regulations and procedures in a certain country are a reflection of the culture, economics, politics, and laws of the country.

Based on the above views, the starting point for this study is a belief that financial reporting practice is an institutional and political practice. As a part of accounting systems, it is a socially constructed reality. From this view, a financial reporting practice can only be developed by reference to a particular setting in which it is embedded (Burchell, et al. 1980; Hopwood 1983; Miller 1994). Moreover, Cooper and Sherer (1984, pp.207–208) concluded that

> [the] study of the institutional context of accounting is a legitimate and necessary area of study for the accounting research...[because] any accounting contains a representation of a specific social and political context.

It is the actors and their cultural, social, and political relationship that determine the quality of financial reporting. Scapen (1994, p. 307) claims that "human beings are a cultural product and accordingly economics need anthropological and evolutionary dimensions". Furthermore, Hodgson (1988, pp.120–124) points out that

> facts do not speak for themselves…the acquisition of knowledge about the world is not simply an individual but a social act...Consequently, contents and objectives of individual self-interest are themselves socially constructed.

Such arguments lead to the notion that it is the institution that forms the cognitive process of actors' conduct and behaviours. As accounting is a social construction (Hines 1988), it is the political, social and cultural environment that shapes the dynamics of financial reporting practice. Political, social and cultural values are frequently institutionalised to achieve certain objectives. Quality financial reporting involves an interplay of culture, power and institutions.

## 2.5 CONCLUSION

This chapter discussed current studies of financial reporting. It was maintained that current studies of financial reporting have been dominated by positive paradigm and have employed agency theory. Such studies view financial reporting as a detachable objective reality, representation of " 'itself, variously, as 'technical', 'neutral', and 'value free'" (Munro 1998).

Considering the narrow focus and weaknesses of current empirical studies, this study takes a different position, and ontologically believes that a financial reporting practice is an institutional and political practice. It is a socially constructed reality. A financial reporting practice takes place in a social and cultural environment, and consequently should be studied within the framework of an interpretive study to understand institutions, power and culture that construct financial reporting practice in a company. Understanding of such practice should be based on a number of theories rather than a single theory.

Thus, the dynamics of financial reporting practice will be well understood under multiple theories, such as institutional theory incorporated with power/political theory and culture. The next chapter will discuss the relevance of institutional theory and power mobilisation in understanding the dynamic of financial reporting practice.

# CHAPTER THREE
# A QUEST FOR RELEVANT THEORY AS A LENS OF UNDERSTANDING

## 3.1 INTRODUCTION

Theory plays important roles in all research, regardless of the research approaches adopted in a study. Theory can be used to "help the researcher make sense of 'what is going on' in the social setting being studied" (Mills 1993, p. 103). Zimmerman (1987, p. 290) also opines that

> ...not all data and facts can be collected and reported—the world and field sites are too complex. Some theory, underlying model, or framework always directs the researcher to those facts considered interesting or important to collect and report.

This study does not employ a single theory as a lens of understanding financial reporting practice. Instead, it draws on insights from multiple strands of organisational, sociological and political theories. The reason is that the use of multiple theories makes it possible to understand the dynamics of financial reporting practice in an organisational setting. The need for understanding corporate phenomena by employing multiple theories is also supported by Monks (1991, p. 15), who argues that

> ...what is needed...is re-examination and synthesis of the language, concept, and evidence of corporate governance research as contained in economics, finance, political science, laws and other disciplines. This kind of re-examination can create a new framework for understanding the concept of corporation and the power it exercises and for developing new theories about how to ensure that it is exercised responsibly.

This chapter will explain the theory underlying corporate financial reporting using a framework of institutional theory incorporating a power-political theory. To analyse and understand the major contribution of such theories to accounting, and to apply the theories to the study of financial reporting practice, it is important to have an understanding of the theories and the issues underlying them. This is because there is almost a confusing concept of institutional theory and power-political theory, which are developed from different points of view.

The first section of this chapter will explain institutional theory, including the reason for adopting this theory, its development, elements of institutions and a critique of institutional theory. The next section will discuss the concept of power relevant to this study. This will be followed by a discussion on Javanese culture as a lens of understanding of financial reporting practice.

## 3.2 INSTITUTIONAL THEORY

Institutional theory of organisations provides a rich and complex view of organisations. It depicts and explicates the existence and power of underlying and taken for granted rules, beliefs, values and norms. Institutional theory is also aimed at explaining how organisational structures and individual behaviour are influenced by the cultural, political and social forces surrounding organisations (Fogarty 1996). This view is shared by Zucker (1987), who believes that organisations are affected by normative pressures arising from external sources and the organisation itself. According to such a view, an organisational structure can be seen as "reflections of rationalized institutional rules" (Meyer and Rowan

1977, p. 340), or “shared knowledge of belief systems” (Scott 1995, p. 13). Furthermore, as noted by Carruthers (1995, p. 324), organisations frequently play an active role in constructing rationalised myths or shaping how the myths are applied in particular instances.

Within the framework of institutional theory, there are two principles that should be understood. First, institutional theory is based on a belief that the institutional environment is socially constructed. This means that the institutional environment can shape individual behaviour and be shaped by individuals acting within the environment. Indeed, the institutional environment is a human fabrication (Berger and Luckmann 1990; Brunsson and Sahlin-Anderson 2000; Carruthers 1995; DiMaggio and Powell 1983; Meyer and Rowan 1977). The way of thinking and individual behaviour can be used to shape programmed actions (Berger and Luckmann 1990) and to generate common responses to a situation (Mead 1934).

Secondly, institutional theory views organisations as open systems. This means that the external environment and actors within organisations play roles in shaping organisational structures and activities (Scott 1987; Selznick 1957; 1966). Smircich (1983a) also contends that environments, as external variables, influence organisations. For Smircich (1983a, p. 353), an organisation is “a particular form of human expression” in which the organised social world has “much less concrete structure...[existing] only as a pattern of symbolic relationships and meaning sustained through the continuous processes of human interaction”.

Moroever, Scott (1998) remarks that organisations cannot exist without the need for adaptation to environmental changes.

He (1998, p. 21) said

> every organisation exists in a specific, technological, cultural and social environment to which it must adapt. No organisation is self-sufficient; all depend for survival on types of relations they establish with larger systems of which they are part.

In addition, Maclagan (1998,p.145) suggests that "...to survive in the progressively more 'turbulent' social environment...organisations would need to adopt and act according to the values that would align them with the expectations of society".

The above assumptions signify that organisations cannot neglect institutional environments and should act in accordance with socially imposed beliefs, values and norms. For institutional theorists (for example, Meyer and Rowan 1977), institutional orders such as rules and procedures are frequently used to sustain appearances that eventually help to generate legitimacy of a certain organisation, rather than generating efficient decisions or results of the organisation. Accordingly, the central view of institutional theory is that organisational contexts are "characterized by the elaboration of rules and requirements to which individual organisations must conform if they are to receive support and legitimacy" (Scott and Meyer 1983, p. 149). Oliver (1997, p. 700) shares such a claim and points out that:

> the basic premise of institutional theory, then, is that firms' tendencies toward conformity with predominant norms, traditions, and social influences in their internal and external environments lead to homogeneity among firms in their

> structures and activities, and that successful firms are those that gain support and legitimacy by conforming to social pressures.

Theses rules, norms, traditions and requirements are recognised as institutions.

Scott (1995, p. 33) theorises that in an organisational context, institutions are defined as “cognitive, normative, and regulative structures and activities that provide stability and meaning to social behaviour”. The reason for organisations to adjust to institutional pressures is to avoid external claims of irrationality and negligible behaviour. Furthermore, organisational conformity to the pressures is directed to gain legitimacy and enhance resources for their life prospects. As noted by Carruthers (1995, p. 317),

> being technically efficient is not the only path to organisational survival. Achieving legitimacy in the eyes of the world, state, powerful professions, or society at large, is another effective survival strategy.

The above arguments imply that institutional theory provides a theoretical lens of viewing organisations, which is useful to understand the dynamics of organisational aspects. Scott (1995, p. xiii-xiv) claims that institutional analysis is useful for answering the following questions:

- Why do organisations of the same type, such as schools and hospitals, located in widely scattered locales, so closely resemble one another?
- How are we to regard behaviour in an organisational setting? Does it reflect the pursuit of rational interest and the exercise of conscious choice, or is behaviour primarily shaped by conventions, routines, and habits?
- Why is it that the behaviour of organisational participants is often observed to depart from the formal rules and stated goals of the organisation?
- Why and how do laws, rules, and other types of regulative and normative systems arise? Do individuals voluntarily construct rule systems that then bind their own behaviour?

- Where do interests come from? Do they stem from human nature, or are they culturally constructed?
- Why do specific structures and practices diffuse through a field of organisations in ways not predicted by the particular characteristic of adopting organisations?
- How do differences in cultural beliefs shape the nature and operations of organisations?
- Why do organisations and individuals conform to institutions? Is it because they are rewarded for doing so, because they think they are morally obliged to obey, or because they can conceive of no other way of behaving?

The following sections of this chapter will elaborate the reason for using the theory in this study, the origins of the theory and other issues concerning institutional theory.

### 3.2.1 Institutional Theory and Studies of Financial Reporting: a Reason

The usefulness of institutional theory in understanding behaviours in organisations has been demonstrated in a number of organisational studies (for example: DiMaggio and Powell 1991a; DiMaggio and Powell 1983; Meyer and Rowan 1977; Meyer and Scott 1983; Zucker 1988). However, most of the studies focused on public and non-profit organisations. Municipal government, public agency, schools and hospitals are examples of the research spotlight (Mezias 1990).

Following the emerging use of institutional theory in organisational studies, the current accounting phenomena have attracted the interest of organisational theorists. This can be seen from a range of literature discussing accounting practice from both an organisational sociology approach (Perrow 1986; Zald 1986) and institutional milieu (Boland 1982; Covaleski and Dirsmith

1988; Meyer 1986). It is also documented that the institutional context of financial accounting has attracted public policy scholars (Cooper and Keim 1983).

However, it is difficult to find accounting research that associates financial reporting practice with its institutional and political context employed in an individual profit organisation, which is highly regulated. Mezias (1990) claims that studies of financial reporting using institutional theory as a lens of understanding can boost the number of organisations to which institutional theory has been applied and augment the increasing sociology of accounting. This study employed institutional theory for two reasons: accounting as a socially constructed reality and flexibility of institutional theory.

#### 3.2.1.1 Accounting is a Socially Constructed Reality

The relevance of institutional theory in understanding the dynamic of financial reporting practice can be related to the notion that accounting is an institution that is socially constructed by individuals, within organisations and outside organisations (Hines 1988; Miller 1994; Hopwood 1994; Munro 1998). Such construction involves different dimensions of behaviour and institutional environments. Hopwood (1994, p. 228) contends that

> ...*accounting* is intimately implicated in the construction of facilitation of the contexts in which it operates. It cannot be extracted from its environment like an individual organism from its habitat...As a social institution, accounting is integrated into customs, values, norms, beliefs accepted in a society...The existence of accounting is determined by culture, customs, norms, and institutions [original emphasis].

Consequently, it has been claimed that “accounting is no longer a neutral device that merely documents and reports the ‘facts’ of economic activity” (Miller 1994,

p. 1). In addition, Munro (1998, p. 201) maintains that "accounting numbers do not simply appear by virtue of their collection and collation; they are *socially constructed"* [original emphasis].

These arguments signify that accounting is an institutional practice that should be understood within a framework of institutional theory. It is useful to consider a view by Ball (1989, p. 1), who contends that:

> accounting and auditing are institutional phenomena, so it is reasonable to assume that they derive many of their properties from the nature of firms as economic institutions. Progress in understanding accounting and auditing, at all levels of abstraction from broad conception of their economic function through to understanding of the reasons for specific accounting and auditing techniques, seems likely to require a theory of the firm that views institutional phenomena as its domain…(quoted by Seal 1993, p. 27).

Antle (1989, p. 103) also remarks that "accounting institutions are the institutions that surround the production and dissemination of financial information both across and within organisations". This argument is based on the notion by Schotter (1981) that a social institution is regularity in social behaviour that is agreed to by all members of society, specifies behaviour in specific recurrent situations, and is either self-regulated or regulated by some external authorities. Scapen (1994) also insists that institutional theory can be used to understand accounting practices because the theory offers an insight into the relationship that exists between accounting and other social institutions.

In addition, Mouritsen (1994, p. 196) highlights that institutional theory plays a crucial role in accounting research because "accounting operates in a complex institutional setting where the location and context of social interaction is important for explaining and understanding it". This argument is also shared by

Carpenter and Feroz (2001, p. 566), who opine that:

> the assumption that, in accounting, economic self-interest motives drive choice is not necessarily inconsistent with the notion that self-interest motive may be determined by organisational, political, and institutional factors. Institutional theory is important in explaining accounting choice in organisations where self-interest maximizing actors cannot exert effective influence over the choices of accounting practices because of their relative power positions in organisations.

Thus, accounting can be seen as a social and institutional practice in organisations (Carruthers 1995; Miller 1994). Moreover, Covaleski, et al. 1996, p. 11) argued that accounting, in the form of institutions, probably shows "a ceremonial mean for symbolically demonstrating an organisation's commitment to rational course of action". Consequently, by showing the existence of companies based on expectation, norms and beliefs that are judged by members of societies, it will help organisations gain support of the community and finally legitimacy (Scapen 1994).

Legitimacy can be achieved when organisations operate their activities in accordance with norms, rules and values of their respective institutional environment (see DiMaggio and Powell 1983; Meyer and Rowan 1977; Mizruchi and Fein 1999; Scott 1995). The institutional environment, as Meyer and Scott (1983, p. 149) claim, within which the organisations operate is "characterized by the elaboration of rules and requirements to which individual organisations must conform if they are to receive support and legitimacy..."

Financial reports, as products of accounting practice, can be used as an attempt to legitimate organisation activities. Financial reporting practice can play a role in constructing a rhetorical story about the organisation's actions that are in compliance with socially imposed beliefs of how organisations should act (Allen and Caillouet 1994; Dowling and Pfeffer 1979). Although such a rhetorical story sometimes does not really have any connection to what organisations do, it is often utilised as a form of symbolic reassurance to meet external expectations and as an attempt to gain a reward through increased legitimacy and resources (Stanton, et al. 2004). For this, Meyer and Scott (1983, p. 235) affirm that

> ...accounting structures are myths...[which] describe the organisation as bounded and unified, as rational in technology, as well-controlled and as attaining clear purposes. The myths are important: they help to hold the organisations together with their justification...[and] they legitimate the organisation with the controlling external environment.

Hence, within the environment, financial reports can be used as a basis for enhancing organisational legitimacy. Financial reports can also play a role as a symbol of an organisation's commitment to external values, such as the need for transparency and public accountability (Coy and Pratt 1998; Hooks, et al. 2002).

According to such views, it is reasonable to claim that it is more fruitful to understand the dynamics of financial reporting practices when the studies are focused on organisational contexts. This can be done by understanding how players within an organisation interact with each other and develop or take rules, norms, and beliefs to shape the organisation. To quote Neu (1992, p. 234)

> [a] social construction perspective provides us with a better understanding of the factors mediating a manager's choices. This approach recognizes that individual, institutional and societal relations influence, constrain and even define one's choices, both at a point in time and over time. Furthermore, a social construction perspective suggests that some practices are not consciously chosen; rather, they are so highly institutionalized that they are taken-for-granted.

Mezias (1990) also provides interesting arguments about why institutional theory is useful in understanding financial reporting practice. He (1990, p. 437–438) insists that:

> 1. Financial reporting practice represents a relatively routine...Designed accounting units gather information for presentation in the financial statements according to professionalized standard operating procedures and programs. The introduction of a new financial statement item, while relatively infrequent, represents more of a mundane than an extraordinary occurrence. The result is an important behavior...dominated by a constellation of forces: regulatory pressures, norms of good practice, and professionalization.
> 2. The range of important players includes the accounting profession, individual organisations, and regulatory agencies, covering phenomena at both the organizational and interorganizational levels. The mix of phenomena at different levels allows for an emphasis that shifts from the individual organization to its context in the institutional environment. Thus, study of financial reporting practices allows for an exploration of isomorphic pressures produced by actions at both the organisational and interorganisational levels.

Mezias' arguments are reasonable, and accordingly, it is not hard to agree with his arguments on the use of institutional theory in understanding financial reporting practice. Other scholars (Boland 1982; Covaleski and Dirsmith 1988; Meyer 1986; and Mezias 1990) also argue that institutional theory provides a valuable lens for understanding accounting practices that govern the external accountability of organisations.

#### 3.2.1.2 Flexibility of Institutional Theory

The second argument on the use of institutional theory in this study is that institutional theory is perceived as a flexible theory, which can be applied for different research approaches. One might claim that institutional theory might be inappropriate for qualitative research in accounting because it has been developed by positive economists. However, such a claim is misleading and has no argumentative support. Indeed, institutional theory is a flexible theory that can be employed not only to justify positive accounting research, but also to help understand the accounting phenomena in qualitative research. The use of institutional theory depends on how a researcher relates the theory to the adopted research approach. It depends on “the research purpose at hand” (Burns 2000). In addition, Bowring (2000) believes that institutional theory, which has been developed by positivists as a theory underlying their research, was previously based on interpretative writing in sociology.

Within the interpretative paradigm, Berger and Luckmann (1984) insist that a reality is socially constructed. For Berger and Luckmann (1984), humans cannot be understood outside the social context within which they are shaped. In organisational milieu, Watson (1998, p. 267) believes that “activities of those who have power and discretion within organisations both shape and are shaped by the societies to which they relate”. Moreover, individuals are socialised into patterns of thinking, roles and responsibilities. People act according to what is seen as appropriate given the actual situation. Thus, what become significant issues is the result of a social process and choice is seen as a reflection of internalised expectations (Vatn 2005, p. 204).

Berger and Luckmann (1984, p. 54) then developed a theory of institutionalisation that refers to a process that happens when there is a “reciprocal typification of habitualized actions by types of actors”. With a similar view, Burrell and Morgan (1979, p. 28) clarify that the social world is “an emerging social process which is created by the individual concerned" and that social reality is "a network of assumptions and inter-subjectively shared meanings". This insinuates that Berger and Luckmann (1984) built the theory within the interpretive paradigm.

It is acknowledged, however, that the work of Berger and Luckmann (1984) gained no popularity in the era because during the 1970s most organisational journals were monopolised and dominated by positive proponents. In fact, as Bowring (2000) has stated, during the decade it seems that no organisational studies were built on the work of Berger and Luckmann (1984). Interestingly, since Meyer and Rowan (1977) published their article "Institutionalized Organizations: Formal Structure as Myth and Ceremony", which is built on Berger and Luckmann's (1984) concept, there have been increasing numbers of studies using institutional theory.

Bowring (2000) argues that the reason for the increasing studies is that the articles published in journals turned away from the interpretative paradigm as built by Berger and Luckmann (1985) toward the dominant functionalist paradigm. Meyer and Rowan's (1977) article was presented in accordance with the style of scientific writing. This included title, author name and academic affiliation, abstract, introduction, literature review, statement of problem, articulation of proposition, proof of propositions, discussion, summary and implications for further research (Bowring 2000, p. 266). These arguments should be reasonable to claim that institutional theory is a flexible theory, which is applicable in both the interpretative and functionalist paradigm.

In summary, there is value in using institutional theory in the study presented here because it enables the researcher to answer the question of "why and how" (Scott 1995) an organisation is committed to quality financial reporting, and what factors, and how such factors influence the organisation in publishing quality financial reports. Institutional theory provides a valuable theoretical lens of understanding the dynamics of financial reporting practice in a certain organisation (such as an insurance company), which operates in a highly institutionalised environment and depends on public financing. For this, DiMaggio (1995, p. 146) argues that "institutional theory suffices to explain most organisational phenomena in certain kinds of fields, for example, those that are *highly institutionalised* and have a weak technical aspect [such as financial institutions; emphasis added]". With a similar view, Fogarty (1996, p. 246) claims that institutional theory tends to function best in "governmental units, *highly regulated organizations*, and those in the private sectors, but which are highly *dependent upon public financing* [emphasis added]".

### 3.2.2 The Genesis of Institutional Theory

The roots of institutional theory can be traced from the studies of economics, politics and sociology. However, two branches of institutional theory (namely institutional economics and institutional sociology), have been used in accounting studies (Burns 2000; Scapen 1994). These approaches are different in terms of their intellectual roots and methodological issues and accordingly, the choice of appropriate approaches in doing accounting research depends on "the research purpose at hand" (Burns 2000).

An old version of institutional economics was introduced by Thorstein Veblen in his works in 1889, 1909 and 1919 (quoted by Burns 2000). This theory emerged as a response to static theory focusing on a rational economic actor. In a sociology context, institutional theory can be traced to the works of Gouldner (1954), Parsons (1956) and Selznick (1957)[14]. Old institutional theory is intended to explain phenomena in a processual context and to explain why and how something has occurred in organisations over time (Burns 2000). Consequently, power and politics become an integral part of old institutional theory in explaining the occurrence of a process during the period.

Institutional theorists believe that members of society identify organisations based on norms and values that the organisations show. For old institutional theory, organisations integrate such social norms and values into the organisational systems to show their sense of symbolic meanings and to offer an alternative existence in a society despite technical and economic reasons (Selznick 1957). Adoption of the accepted norms and values can be seen as media of the organisations to sustain their behaviour[15].

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[14] Old institutional economics is different from new institutional sociology (DiMaggio and Powell 1991; Scott 1995) which has been employed in accounting studies, especially management accounting research (see for example Carruthers 1995; Covaleski, et al. 1993; Covaleski, et al. 1996). Although old institutional economics might overlap with new institutional sociology, both theories focus on the importance of power as a key facilitator of institutional changes. New institutional sociology pays more attention to given institutions, whereas old institutional economics is more concerned with emergency, continuity and institutional changes over time (Scapen 1994).

[15] In organisations, types of beliefs, norms and values are collectively referred to "organizational culture" (Brown 1998).

The process by which social norms and values are introduced and adopted into an organisational system is known as institutionalisation. Selznick (1957, p. 16) describes this process as follows:

> It [institutionalisation] is something that happens to an organization over time, reflecting the organization's own distinctive history, the people who have been in it, the group it embodies and the vested interest they have created, and the way it has adapted to its environment.

Within old institutional theory, institutionalisation of beliefs, values and norms depends on the dynamics of organisational factors such as specialisation and technical design (Selznick 1957). The institutionalisation process can also be claimed as a view to explain why certain organisations continuously use ineffective and obsolescent behaviour and actions (Pfeffer 1981).

Old institutional theory also suggests that to institutionalise norms and values in organisations, those who hold power, such as leaders, must be able to motivate and drive members of an organisation to follow their behaviour. Hence, Selznick (1957, p. 27) claims that a leader can be seen as "an agent of institutionalization". A leader is responsible for determining and sustaining organisational beliefs, values and norms. They also play an important role in ensuring that such beliefs, values and norms are in congruence with socially acceptable beliefs, values and norms. This means that a leader plays an important role in sustaining an organisational identity and in making their organisation different from others (Schein 1995; 1996; 2004). To sustain the organisational identity and power, institutional theory relies on a view that once institutionalised, the norms and values become guides for organisational members to show what constitutes accepted behaviour (Simon 1957). Consequently, individual actions and behaviour can be seen as a manifestation of the institutionalised rules and procedures of the organisation.

To sum up, old institutional theory is concerned with the understanding of what constitutes values, how organisations adapt or change their culture and structure to socially accepted values, and how such values become weak and de-institutionalised (Selznick 1996). Although old institutional theory discusses the aspect of external influences, the discussion has been focused on the explanation of the institutionalisation of normative controls, such as the types of beliefs, values and norms (Hirsch and Lounsbury 1997; Mizruchi 1999; Scott and Christensen 1995; Selznick 1957).

### 3.2.3 New Institutional Theory

The new institutional theory that emerged during the mid 1970s was pioneered by Meyer and Rowan (1977) and Zucker (1977). New institutional theory was then developed and elaborated further by DiMaggio and Powell (1983), and Meyer and Scott (1983). This theory has influenced organisational studies including accounting until recent days. The emerging studies using institutional theory has led DiMaggio and Powell (1991) and Scapen (1994) to claim that institutional theory has experienced a renaissance throughout the social science.

#### 3.2.3.1 Perspectives of New Institutional Theory

New Institutional theory is founded on a belief that the structures and behaviours of an organisation depend on the characteristics of the environment in which the organisation's activities take place (DiMaggio and Powell 1983; Meyer and Scott 1983). Organisational practices are influenced by institutional environments and internal institutions. Institutional environments can include social, political and economic environments, and these make an organisation aware and adapt to the environment in order to get support and legitimacy from the environment (DiMaggio and Powell 1983; Meyer and Scott 1983; Zucker 1977). On the other hand, internal institutions can include the objectives, structure and culture of the organisation.

Accordingly, external factors such as the given socio-cultural norms, relationship among organisations and political pressures by government and other authoritative bodies have pressured organisations to change their routines (Burns and Scapen 2000; Dacin 1997; DiMaggio 1991b; Scott and Christensen 1995). Moreover, changes in the individual composition of organisations can also be seen as a pressure to change (Peter and Pierre 1998). According to Scott and Meyer (1991, p. 120), "organizations are embedded in larger systems of relations" that are denominated by the "societal sector". This refers to the group of organisations that offer similar services, products or functions, including its major suppliers, customers, owners, regulators and competitors (Scott and Meyer 1991)[16].

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[16] In the terminology developed by DiMaggio and Powell (1983) the concept of the societal sector is called as an "organizational field".

DiMaggio and Powell (1983) highlight that the system of relations are organised at broader and wider levels, and organisations are allied into non-local and vertical hierarchies. Consequently, how the societal sector is structured significantly shapes organisational features and structures. This occurs especially when organisations are controlled by technical or institutional processes, the structure of decision making, the numbers of levels at which organisations have developed and the nature of inter-level controls (Scott and Meyer 1991).

New institutional theory claims that organisations are designed to comply with practices and procedures, which are seen as socially accepted rationalisations of how to structure organisation operations (Meyer and Rowan 1977). Hence, Fogarty (1996) contends that the concept of rationality develops and changes. New institutional theory views that rational rules and routines are adopted by organisations to ensure that organisations' actions are legitimate not merely for the reason of efficiency (Meyer and Rowan 1977; Scott and Meyer 1983; Oliver 1997). In other words, as Pfeffer and Salancik (1978) believe, rational rules and routines are adopted to sustain the trust of external stakeholders in the operations of organisations.

In line with the above arguments, organisations will struggle to ensure that the institutionalised rules and routines are visible for external constituents (Scott 1998). For example, in light of socially responsible accounting, a company discloses social and environmental information for the purpose of gaining legitimacy and sustaining its image in the eyes of stakeholders. Logically, congruence with a social expectation is a way of improving a company's capability to receive continuing resources, to reduce the likelihood that its behaviours are questioned and to improve the prospect of survival (Albernathy and Chua 1996; Covaleski, et al. 1996; DiMaggio and Powell 1983; Meyer and Rowan 1977; Scott 1987; Tolbert and Zucker 1983).

The above arguments demonstrate that new institutional theory draws attention to macro aspects concerning the understanding of external pressures to change, rather than the internal dynamics of the changes. It is the environment that makes "organisations in their own image" (Carruthers 1995, p. 315). In addition, formal organisational structures arise as reflections of rationalised rules, which function as myths and give legitimacy and stability to organisational resources (Meyer and Rowan 1977). It is not technical criteria that determine structure but isomorphism. Carruthers (1995) noted that the process of isomorphism "is a cultural and political one that concerns legitimacy and power much more than efficiency alone" (p. 315). Four types of isomorphism can be distinguished (DiMaggio and Powell 1983): competitive, coercive, mimetic and normative. Competitive isomorphism occurs when the forces of competition will eventually impose on organisations one single best way of doing things (Carruthers 1995). The other three terms of isomorphism will be discussed in the following section.

#### 3.2.3.2 The Mechanism of Institutionalisation

DiMaggio and Powell (1983) developed a scheme of classification to identify a mechanism that drives the homogeneity of companies (institutionalised isomorphism). They (1983) point out that there are three forces shaping institutional behaviour. First, pressure to obey rules and regulations issued by an individual or organisations (coercive isomorphism). Second, the need for self-adjustment to the objectives to reduce uncertainty by imitating procedures adopted by other organisations (mimetic isomorphism). Third, a pressure to self-adjust to the norms and regulations developed and released by professional bodies (normative isomorphism).

Scott (1995) defines such a mechanism in response to environmental pressures as three institutional pillars by which they become part of organisational behaviour. Scott (1995, p. 33) remarks that

> [i]nstitutions consist of cognitive, normative and regulative structures and activities that provide stability and meaning to social behaviour. Institutions are transported by various carriers—cultures, structures, and routines—and they operate at multiple levels of jurisdiction.

For Scott (1995), cultural carriers rely on "...codified patterns of meanings and rule systems" (p. 53). Social structural carriers also refer to the patterned expectation or "role systems" and create structural isomorphism. Finally, "routines as carriers rely on structured activities that can embody institutions" (p. 380). The following section will elaborate the role of isomorphism in institutional theory.

#### 3.2.3.2.1 Coercive Isomorphism

Coercive isomorphism takes place when the organisation changes in response to pressures from other organisations on which the changing organisation strongly depends for resources and support (DiMaggio and Powell 1983). Tolbert and Zucker (1983) argue that when an organisation operates in a wider network, the legitimated changes in the more powerful organisations provide a pressure to change on the dependent organisation. In other words, power is a central variable in the coercion (Scott 1995).

Scott (1991) suggested that two types of pressure should be distinguished under this category: pressure by means of authority and pressure by means of coercive power. Changes forced by authority occur with less resistance and more rapidly than those imposed by coercive power. Structural changes, which are forced by authority, will achieve higher levels of compliance and stability because these changes are less superficial than change enforced using coercion (Scott 1991).

An example of a coercive mechanism is the case of public organisations on which a pressure to comply with other institutions occurs when survival of one department strongly depends on resources and support of other government departments (DiMaggio and Powell 1983; Meyer and Rowan 1977). In financial reporting practice, an example of coercive isomorphism is the mandatory requirement of companies to obey accounting standards as promulgated by authoritative bodies when the companies want to raise capital through capital markets. This implies that the companies are dependent on other organisations.

#### 3.2.3.2.2 Mimetic Isomorphism

Mimetic isomorphism is driven by uncertainty and imitation processes. In other words, mimetic isomorphism takes place when an organisation is facing a high level of uncertainty. Uncertainty about organisational technologies, goals and environmental expectations often force organisations to imitate other organisations. Carruthers (1995) claims that organisational fashions are likely to spread through this mimetic isomorphism. In social life, organisations tend to copy models of operation from successful companies and to be receptive to fashionable business techniques to protect them from uncertainty (Abrahamson 1996; Granlund and Lukka 1998). Such organisations homogenise or imitate themselves to other organisations that are believed to be legitimate or successful for the purpose of survival or to reduce uncertainty (see Baldridge 1977; DiMaggio and Powell 1983; Tolbert and Zucker 1983).

An example of mimetic isomorphism in financial reporting practice is the tendency of one company to imitate another company's financial disclosure by disclosing social and environmental information in financial reports (see for example Deegan and Gordon 1996; Patten 1992). This is done for the reason of gaining legitimacy. Moreover, Gordon and Miller (1976) suggested that management perceptions of environmental uncertainty have a major influence on the nature and form of accounting information produced by a company.

#### 3.2.3.2.3 Normative Isomorphism

The last institutional isomorphism is normative, which is based on a premise that organisations change because of the process of professionalism. Indeed, professions play an important role in the diffusion of similar orientations and dispositions in determining organisational behaviours. This process occurs through two mechanisms: a transmission of norms by professionals and the development of professional networks (DiMaggio and Powell 1983).

The process of normative isomorphism can be seen in accounting practices employing a number of accounting methods, techniques and principles to manage organisations in accordance with what has been learned from accounting education and training. Thomas (1989) claims that to deal with environmental uncertainties, a company will rely on professional specialists, such as accountants and auditors, who will wield their influence on corporate strategies, including financial reporting decisions.

#### 3.2.3.2.4 Reasons for Isomorphism

Two explanations can be used to justify why organisations tend to become isomorphic with their environments (Meyer and Rowan 1977). These reasons are related to the two basic assumptions of institutional theory. The first is that organisations are open systems, which become harmonised with their environments through several exchanges and technical interdependencies. DiMaggio and Powell (1983, p. 73) explained as follows:

> ...each of the institutional isomorphic processes can be expected to proceed in the absence of evidence that it increases internal organizational efficiency. To the extent that organizational effectiveness is enhanced, the reason is often that organizations are rewarded for their similarity to other organizations in their fields. This similarity can make it easier for organizations to transact with other organizations, to attract career-minded staff, to be acknowledged as legitimate and reputable, and to fit into administrative categories that define eligibility for public and private grants and contracts. None of this, however, ensures that conformist organizations do what they do more efficiently than do their more deviant peers.

The second reason is related to the fact that the institutional environment is a socially constructed reality, which is reflected in organisational structures. This implies that organisations are viewed not only as institutions in themselves, but also as products of their institutional environments. Institutionalised rules that function as "myths" (Meyer and Rowan 1977) are absorbed by organisations to conform to their environment. Those "myths" are rational and impersonal prescriptions, which are highly institutionalised. They also frequently identify social purposes as technical ones. To the extent that rules are considered proper, adequate and rational, organisations must incorporate them to avoid illegitimacy (Meyer and Rowan 1977). The incorporation of legitimised elements boosts the commitment of internal participants and external constituents to organisation's actions, and protects them from having their conduct questioned.

### 3.2.4 Organisational Responses to Institutional Pressures

Institutional pressures do not automatically force an organisation to conform. Indeed, various powers and interests within an organisation will determine how its actors respond to such pressures. Studies of new institutionalism suggested that organisations could generate different responses when they are facing institutional pressures.

Dowling and Pfeffer (1975) and Lindblom (1994) provide the means or strategies by which an organisation seeks legitimacy. These strategies can be described as follows:

(1) The organisation can adapt itself to conform to prevailing definitions of legitimacy by changing its behaviour and informing the relevant public about the actual changes.

(2) The organisation can modify external expectations to concur with current firm performance.

(3) The organisation can manipulate social perception by associating itself to symbols, values or institutions which possess a strong legitimacy base.

(4) The organisation can alter the existing social definition of legitimacy to match present organisational practice, without changing its behaviour.

Oliver (1991) provides a detailed review of organisational responses to institutional changes. Oliver (1991, p. 151) argues that organisational responses to institutional pressures

> ...will vary from conforming to resistant, from passive to active, from preconscious to controlling, from impotent to influential, and from habitual to opportunistic, depending on the institutional pressures toward conformity that are exerted on organizations.

This claim is consistent with the argument by Pfeffer (1981), suggesting that the existing institutions will restrict or constrain an organisation's ability to make a change.

Oliver (1991) offers five strategic responses to the institutional pressures: acquiescence, compromise, avoidance, defiance and manipulation. Acquiescence means conformity to institutional pressures through three forms: habit (following invisible, taken-for-granted norms), imitation (copying successful institutional models), or compliance (obeying rules and regulations).

The second response, compromise, refers to a strategy by which, when internal pressures for efficiency conflict with the external institutional pressures, organisations tend to compromise by balancing, bargaining with or pacifying the external constituents (Oliver 1991). Compromise, as Oliver (1991) suggests, can take three forms, including balancing (balancing the expectation of multiple constituents), placating (placating and accommodating institutional elements) and negotiating (negotiating with the institutional stakeholders).

The third type of organisational response, avoidance, refers to a strategy employed by an organisation to avoid the necessity of conformity to external pressures. Within this response, as Oliver (1991) suggests, organisations can choose one of the three avoidances: concealing (disguising nonconformity), buffering (loosening institutional attachment), or escaping (changing goals, activities or domains).

The fourth response, defiance, is a more purposive form of resistance by organisations to external pressures. Oliver (1992) argues that organisations can defy institutional pressures by means of dismissal, challenge and attack. Organisations can ignore institutional pressures when the pressures are perceived as low or inconsistent with organisational objectives. Organisations can also confront institutional pressures when the expected changes are irrational. In addition, Oliver (1991) contends that organisations can attack institutional pressures when the organisations perceive that their rights, autonomy or privileges are in threat.

The fifth strategic response, manipulation, is a strategy intended to show how organisations redefine the organisational reality perceived by others. This is the most active response to external institutional pressures. To quote Oliver (1991, p. 157), such a strategy is used to "actively change or exert power over the content of the expectations themselves or the sources that seek to express or enforce them". Oliver (1991) remarks that organisations can manipulate institutional pressures by importing influential constituents, shaping values and criteria (manipulation of value and norms) and dominating institutional constituents and process. In other words, manipulation can be done by using tactics of co-opting, influence, and control (Oliver 1991).

Whatever responses the organisation makes, it is suggested that the existing institutions play a role as a constraint of the implementation of a certain response (Scapen 1994). The reason organisations adapt to the environment is that they want to be seen as competent and acceptable. Accordingly, to comply with socially accepted beliefs, organisations tend to adopt similar structures and practices (Covaleski, et al. 1993; DiMaggio and Powell 1983).

### 3.2.5 Institutional Theory: a Critique

The above discussion shows that from its genesis, institutional theory can be divided into two different theories: old institutional theory and new institutional theory. There is a dichotomy in explaining institutional theory. Old institutional theory focuses on the micro level of an organisation, whereas new institutional theory focuses on the macro level. Consequently, there have been critiques of institutional theory—especially the new institutional theory. Indeed, an oversimplified view of organisations described by new institutional theory has been criticised by a number of scholars (see for example: Christensen, et al. 1997; Kraatz and Zajac 1996; Selznick 1996).

In addition, a more specific critique has been directed to new institutional theory, which is perceived as insensitive in regard to the role of an actor, power, and interest (Boons and Strannegard 2000; Carruthers 1995; Perro 1985; Scott 1995). It seems that new institutional theory ignores the fact that actors and their abilities are capable to influence and shape organisations. In other words, the scholars argued that new institutional theory ignores power and politics in the process of institutionalisation.

It should be noted that institutional theory actually does not neglect the role of power in organisations. Critiques on the power aspect of institutional theory might be based on the fact the scholars see power from the perspective of self- interest as usually employed in agency analysis. However, it can be argued that institutional theory considers the role of power especially in the process of institutionalisation. Bourdieu (1990) claims that individuals are affected by the practice of behaviour in its immediate environment. Thus, an individual is not only influenced by formal structures but also by the practice of actors. The practice of an actor might be able to influence behaviour of other individuals and could shape an organisational reality. For Shepsle (1989), institutional change occurs when a sufficient number of individuals are able to disrupt institutions. Yet, the number of individuals is not the main determinant of change. This argument shows that the power position of individuals is important. Powerful individuals who are not satisfied with the current situation can dominate the process of an institutional change.

In a similar view, Levi (1990) and Hall (1986) argue that institutions are important because they also shape power and preferences of actors. Indeed, Levi (1990) notes that institutions both contain and create power. Hall (1986, p. 19) believes that

> the organization of policy-making affects the degree of power that any one set of actors has over policy outcomes...Organizational position also influences an actor's definition of their own interests, by establishing institutional responsibilities and relationships to other actors.

Moreover, Clegg (1979) remarks that the institutionalisation of organisational rules and routines reflects the power of organisational actors' translations and use of social expectation. This means that although external pressures can provide pressures for homogeneity, they do not provide the main motivation for change. Instead, it is power and conflicts of interest within an organisation that motivate how powerful actors respond to the pressures. The powerful actors or leaders interpret the pressures and will mobilise power sources to determine their organisational responses (Finstad 1998; Jepperson 1991). Thus, the claims that institutional theory ignores power issues cannot be accepted.

The main shortcoming of institutional theory is not whether institutional theory ignores power but institutional theory does not mention a specific concept of power in discussing the process of institutionalisation. From the results of field research, it was found that institutional theory is useful to provide understanding of the reason why and how a company is committed to quality financial reporting practice even though the theory is insufficient for fully explaining the whole aspect of how a leader institutionalises rules in the company to shape the behaviour of organisational members to commit to quality financial reporting.

The field research of this study suggested that other theories are needed to complement institutional theory to gain a more comprehensive understanding of the dynamics of financial reporting practice. Theories concerning power and politics will be useful to support institutional theory in explaining the research finding. In line with the use of power-politics theory, DiMaggio (1995, p. 157) claims that

> once institutional and political models are regarded as complementary tools for understanding different aspects of institutional phenomena, rather than as antagonistic world views, the range of problems to which institutional insights are relevant is likely to broaden.

The use of complementary theories is also consistent with arguments by Humprey and Scapen (1996, p. 91) who said that “the researcher may need to refocus, regrind or reshape the chosen lens and even combine it with other lenses in order to secure a coherent theoretical framework“. Consequently, this study employs a theory-triangulation approach to explain the dynamic of financial reporting practice.

The next section will discuss the concept of power that is perceived as fitted to complement institutional theory to understand the dynamics of financial reporting practice in an insurance company.

## 3.3 CONCEPT OF POWER

### 3.3.1 Power and Organisations: a Review

Organisations can be viewed as complex systems of individuals and coalitions with different interests, beliefs, values, preferences, perspectives and perceptions. Shafritz and Ott (1996) claim that organisations are assumed to be institutions whose major purpose is to achieve certain goals that are determined by people in positions of formal authority. Thus, power and politics are often part of an organisation, and should be understood as fundamental and important processes of managing an organisation. Power and politics are basic processes that occur in many organisations (Pfeffer, 1981). This includes the influence of power in financial reporting practice, as financial reporting practice is a political process concerning the supply of information. However, power and politics have been neglected in organisational studies as well as studies of financial reporting practice.

A number of factors might explain the reasons for not considering power in financial reporting practice. One reason is that the concept of power is relatively problematic. Indeed, as Miller (1982) remarks, there is little scholarly consensus on how to define power, how to observe power and measure it, or even how to think about it. Pfeffer (1981, p. 2) also argues that power has been neglected for several reasons:

> first, the concept of power is itself problematic in much of the social science literature. In the second place, while power is something, it is not everything... and third, the concept of power is troublesome to the socialisation of managers and the practice of management because of its implication and connotations.

Discussing power is much easier when the concept is easily understood. People will understand what power is when they are able to define it (Bierstedt, 1950). One interesting statement regarding the fact that power is problematic is that proposed by Wrong (1979), "power is regarded as influence, or influence as a form of power… Authority is a sub type of power, or power and authority are distinct and opposite. Persuasion is a form of power; it is not power".

Secondly, as Pfeffer (1981) argues, concepts of power have not been widely discussed in organisations, although Russel (1939) believes that power is a fundamental aspect in social science, and Bierstedt (1950, p. 784) claims that "without power there is no organisation and without organisations there is no order". Discussions of organisations and accounting have been conquered by the issues of productivity and efficiency (Tinker 1991). Consequently, as financial reporting practice takes place in organisations, power has also been ignored in discussing financial reporting practice.

Lastly, the reason for ignoring power in studying financial reporting might be the fact that discussion of financial reporting has been dominated by the framework of agency theory and signalling theory by assuming that in providing information, general equilibrium of demanded and supplied information is achieved by market forces.

To discuss power, it needs to be understood what power is and how actors exercise power in organisations. Pfeffer (1981) points out that in order to assess power one must be able to estimate (a) what would have happened in the absence of the exercise of power, (b) the intention of the actor attempting to exercise power, and (c) the effect of action taken by the actor on the probability that what was desired would in fact be likely to occur. The next section will discuss different views of power and justify a concept of power which is considered as relevant for this study.

### 3.3.2 Different Views of Power

It is well documented that there is no common agreement among sociologists and social scientists on the theoretical approach and definition of power in organisations and societies (Bartlett 1980; Bierstedt 1950; Clegg 1975; Miller 1982). Nevertheless, researchers agree that power is a relational subject that manifests itself in the social structures of class, race, sex, occupations and everyday interactions and exchange relations (Sisaye 1997). Studies of power have been conducted at different levels of analysis and various contexts such as conflict and functionalist sociology, social psychology, political science and organisational behaviours (Bartlett 1980). Although a detailed analysis of power concepts is beyond this discussion, there needs to be an analysis of the concept of power that is viewed as relevant for this study. The concept of power can be understood from perspectives of conflict and functional sociology, political science, organizational behaviour, and social psychology (Bartlett 1980).

In the view of conflict and functional sociology, the concept of power is characterised by a relationship of dependency among actors (Dahl 1957; Emerson 1962; Weber 1947). For example, Weber (1947, p. 152) describes power as "the probability that one actor within a social relationship will be in a position to carry out his own will despite resistance, regardless of the basis on which this probability rests". However, the concept of power based on conflict has been criticised by other scholars. Parsons[17] (1967), for example, disagrees with the conflict perspective and argues that power can be defined without considering conflict because power can be exercised through cooperative and goal-oriented activities. Such a critique leads to another view of power, such as a concept of power in political science.

In political science, power in a sense of community relationship is determined by the outcomes of community decision-making processes (Bartlett, 1980). Within this perspective, a number of studies (Dahl 1961; Luke 1974; Polsby 1960) develop a pluralist view of the concept of community power, and claim that power is diffuse between different groups and depends on the issues

[17] Parson (1967 p. 41) defines power as "the…generalized capacity to secure the performance of binding obligations by units in a system of collective organization when the obligations are legitimised with reference to their bearing on collective goals, and where in case of recalcitrance there is a presumption of enforcement by negative situational sanctions—whatever the actual agency of that enforcement".

they face[18]. Lukes (1974) argues that the exercise of power can occur without overt or covert behaviours, but by those in a position of defining agendas. Nevertheless, a number of critiques are directed at the pluralist concepts. For example, Bachrach and Baratz (1962, p. 949) disagree with the concept of power offered by pluralists and questioned

> can the researchers overlook the chance that some person or association could limit decision-making to relatively non-controversial matters by influencing community values and political procedures and rituals…

Such a weakness has attracted other scholars to define power from another point of view such as a concept of power in organizational behaviour.

In the context of organisational behaviours, power refers to a strategic contingency as discussed by Salancik and Pfeffer (1977). They (1977) claimed that organisations are typically run by a dominant coalition of individuals or group that accrues power on the basis of being able to cope with critical organisational problems. The contingency approach has also invited critiques. For example, the contingency approach tends to see power as structural differentiation of organisations (Bartlett 1980). For this, Hickson, et al. (1971, p. 217) claim that:

> …when organizations are conceived as interdepartmental systems, the division of labour becomes the ultimate source of intra-organizational power, and power is explained by variables that are elements of each unit's task, its functioning, and its links with the activities of others subunits.

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[18] Lukes (1974) suggested that a study of power should take into account the institutionalisation of bias. According to Lukes (1974, p. 23) "A may exercise power over B by getting him to do what he does not want to do, but he also exercises power over him by influencing, shaping or determining his very wants…". Pluralists believe that when answering the question who lead the community, pluralists claim that only a well-defined group can control power.

Within such approach, power is assumed as relatively static property of structuring of relationship and neglects certain situations, for example, the ability of certain subunit in developing new power structure based on their personal characteristics (Bartlett 1980). This refers to bases of power that are discussed within the social psychology perspective.

In the perspective of social psychology, power is viewed in terms of influence that is related to psychological changes (French and Raven 1959; Kelman 1974). French and Raven (1959, p. 608) for example view power as follows:

> [*s*]ince we shall define power in terms of influence, and influence in terms of psychological changes, we begin with a discussion of change. We want to define change at a level of generality, which includes changes in behaviours, opinions, attitudes, goals, needs, values, and all other aspects of the person's psychological field.

According to such a view, French and Raven (1959, pp.609-610) consider power as "the conceptual property of potentiality", in which power should come out of "[*an*] intentional influence attempt", and by considering another condition, that is, "with respect to a specified system because the power of (one actor over another) may vary greatly from one (situation) to another".

Kelman (1974) also views power from the perspective of a social relationship of actors. This view is based on a claim that social influence is seen as changes in behaviour that are socially induced. Kelman (1974, p. 136-139) said

> if we reformulate the three conditions for positive influence in terms of dimensions, we come up with three basic determinants of the probability of influence: 1) the relative importance of the induction (presentation of available alternative behaviours), 2) the relative power of the influencing agent, and 3) the pre-potency of induced behaviours (extent to which the behaviours is perceived by the influence target to be most relevant to his goal achievement).

As a result, Kelman (1974, p. 140) sees power as follows:

> …the relative power of the influence agent as the extent to which the target perceives the influence agent to be instrumental to goal achievement; that is; that the influence agent has ability to control some conditions for the target's goal achievement as well as the perceived likelihood that he will use that control.

Considering Javanese culture, which is adopted in this study, a concept power based on a social relationship among actors (French and Raven 1959; Kelman 1974) is perceived as relevant for this study. Based on the analysis of power, argument in this study is that power is the ability of one actor (A), in social relationship on organisations, to successfully influence the behaviours of another actor (B), by which the ability of actor (A) in influencing depends on the perception of another actor (B) on the ability of actor A in mobilising dimensions of power in the relationship. This view implies that power exists as a consequence of a social interaction among actors.

According on such a view, a given social actor has more power with respect to some social actors and less power with respect to others (Kelman 1974). Consequently, different actors can bring different perceptions and interpretation to each situation. The perception of influenced actors on the capabilities of influencing actors in mobilising power will determine whether an actor is powerful or powerless and able to achieve the targeted outcomes (Bartlett 1980). It is also important to note that the use of power in organisations could lead to resistance. Hence, the successful use of power to some extent depends on a leadership style in an organisation. The next section will discuss the relationship between resistance and leadership.

### 3.3.3 Leadership and Resistance

The exercise of power in an organisation can lead to resistance from its organisational members. Indeed, conflict and resistance always come along with the process of change (Hardy 1991; O'Connor 1993; Scapen 1994; Vasu et al. 1998). Resistance to change might come from a variety of sources. Brown (1998) asserts that there are at least five sources of resistance: selective perception, habit, security, economic status and esteem. Selective perception refers to a condition where the reality of an organisation that is defined by subordinates is at risk of being changed (Brown 1998). The second source of resistance comes from habit, that is, a condition occurs when members of an organisation are forced to change institutionalised behaviours (Brown 1998). Security refers to psychological aspects to which resistance could occur when the psychological security of subordinates is threatened. Moreover, Brown (1998) believes that resistance can occur when subordinates believe that new rules or norms shrink their economic status. Finally, the change in esteem as a consequence of new rules or norms could lead subordinates to resist organisational change (Brown 1998).

Resistance could also occur when members of organisations in lower hierarchical positions have superiority in certain resources such as information and skills. Subordinates can influence a superior, their leader, not to make a change in the institutionalised activities. Indeed, lower participants in any organisation can gain some control over power resources such as information, persons and instrumentalities and thus exert some influence over their superiors by building up dependency relationships (Fulop and Linstead 1999; Mechanic 1962).

To avoid resistance and to make organisational changes occur, the organisation needs good leadership. As leadership in organisations has usually been derived from legitimate power, a leader with sources of formal influence can determine organisational decision outcomes[19]. A leader of an organisation can utilise power to not only ascertain the organisational reaction to pressures for change, but also to deal with the results of change (French 1956).

Because leadership is derived from legitimate power, the process of influence occurs through a basis of power such as hierarchical position, expertise, and personal charisma. These sources of power refer to leadership power which can be used to support organisational members in promoting changes and influence their behaviour. In an organisation, the CEO and top management, for example, can be seen as the dominant coalition leaders of the organisation that are able to affect the source of subunit power (Lachman 1989).

It is also important to note that the concept of leadership power covers both technical and conceptual abilities, as well as political skills. In regard to technical and conceptual abilities, Hinkins and Schriesheim (1988, p. 48) remark that managers/directors who hold leadership power have "the ability to administer

[19] McClelland (1994, p. 482) defines influence as follows: "we say one person influenced another when the first has been able to tell the second what to think or to do. We also describe it as influence when the second person imitates the behaviour of the first. [*For influence to occur*], the second person must accept the suggestion or imitate the action..."

to another person information, knowledge, or expertise”. However, technical and conceptual abilities are not the only component of leadership power because within a political environment, leadership power has another meaning (Rourke 1976).

Leadership power can be seen as the political ability of the leader to accomplish the goals of a sub unit by “ensuring a favourable response to the agency from outside groups and organisations that control resources upon which it [*the subunit/agency*] depends” (Rourke 1976, p. 241-242). For Yukl (1981, p. 59), leaders in an organisation can employ power in two general ways:

> 1. they can utilize power to control and conquer subordinates by keeping them weak and dependent on the leader or,
> 2. they can exercise power in a cautious, responsible manner with the objective of internalising motivation and organizational commitment in subordinates (cited by Wilson 1995).

By considering leadership power, a leader plays an important role in reconciling the organisation’s internal endeavour with environmental pressures (Selznick 1957; Bennis and Nanus 1985). This means that to understand how organisations build their image, the leader’s values and style need to be understood. For Bass (1990), leader’s values are influenced by a number of factors such as education, personality, cognitive style, and social relationship.

A charismatic leader is the ultimate in personal power and is endowed by followers with qualities such as omniscience, virtue, infallibility, and wisdom (Bass 1990). These charismatic attributes guide followers to identify and develop strong emotional bonds of affection with the leader that eventually result in fierce personal loyalty. Such emotional attachment enables the leader to exercise a significant amount of influence and power over subordinates. Thus, leadership styles can shape individual and group behaviour as well as the performance of the organisation. Leaders can "influence organizational attributes, processes, and outcome: by making decisions that affect the organization; and by shaping the thoughts, feeling, and actions of people inside and outside the organizations" (Mowday and Sutton 1993, p. 210).

Leaders can be seen as agents of changes (Shamir 1999). They are wary of their operating environment and have to consider the need for adaptation when changes arise in the environment (Selznick 1957). Hence, a leader must be able to either change or modify organisational culture to reflect the changes (Shamir 1999). This is because when a leader discards the institutionalised activities and take new values and beliefs, the existing members of the organisation might still operate with the old values and beliefs which lead to resistance (Selznick 1957; Greenwood and Hinings 1996). Trice and Beyer (1993) also assert that in the process of change, a leader is responsible for redefining organisational reality or organisational culture. Trice and Beyer (1993, p. 163) remark that:

> members are unlikely to give up whatever security they derive from existing cultures and follow a leader in new direction unless that leader exudes self-confidence, has strong convictions, a dominant personality, and can preach the new vision with drama and eloquence.

A well-defined organisational reality in the eye of other organisational actors will enable a leader to direct the actors to comply with organisational rules, values, norms, and beliefs and to avoid resistance.

In addition, to secure compliance, a leader might rely on persuasion and negotiation. LaValle (1994, p. 94) argues that

> persuasion is exercised by those people who are able to orient the behaviour of others simply by offering the information and arguments which convince them that the action advocated is the 'most proper' or 'right'.

Moreover, because persuasion encourages close relationships among actors without the risk of external sanction, Yukl and Falbe (1991) claimed that personal power was found to be more important than positional power as a determinant of task commitment and ratings of managerial effectiveness. Rudolph and Peluchette (1993) also argue that persuasion is a readily available tool that leaders can use to encourage feelings of self-importance, power and personal mastery. However, it should be taken into account that persuasion is commonly used among actors who share similar cultures (LaValle 1994), professional backgrounds and interest (Sisaye 1997).

In relation to response to institutional pressures, political actors or leaders within the organisation must be able to interpret the pressures and mobilise power in the organisation to control or influence the organisational response and to cope with the outcome of the pressures (Finstad 1993; Jepperson 1991). By so doing, targeted objectives of the organisation can be reached without any significant resistance from other members of the organisation. The following section will discuss the role of power mobilisation in an organisation, especially an organisation that is committed to quality financial reporting practice.

### 3.3.4 Power Mobilisation

Understanding power in organisations should not be focused on something that is possessed but should be focused on something that is exercised. This is because organisational life is never static but dynamic. An organisation always moves, adapts and changes in regard to its environmental context. Thus, power in organisations must be understood as a continuous process within a social relationship. Foucault (1979, p. 334-335) remarks that

> power is not something that is acquired, seized or shared, something that one holds and allows to slip away; power is exercised from innumerable points, in the interplay of non-egalitarian and mobile relations.

Apropos to understanding of the way a leader directs members of the organisation to commit to quality financial reporting practice, power must be exercised and mobilised in an organisation. A basis of power is not enough to accomplish the intended outcomes and individuals must act. To avoid or reduce complications such as resistance and conflicts when exercising power, individual's actions must be in congruence with the context of organisational uniqueness (Buchanan and Badham 1999). Accordingly, an actor must have certain characteristics to exercise power.

Mintzberg (1983) offers three basic conditions of the exercise of power. To exercise power an actor requires (1) some source or basis of power such as a resource, technical skill and body of knowledge, coupled with (2) the expenditure in energy in a (3) politically skillful way when necessary. Mintzberg (1983) remarks that political skill means the ability to use the base of power effectively –

to convince those to whom one has access, to use one's resources, information, and technical skills to their fullest in bargaining, to exercise formal power with a sensitivity to the feelings of others, to know where to concentrate one's energies, to sense what is possible, to organise the necessary alliances. In addition, Yukl (1989) highlights that there are three possible outcomes of the exercise of power: commitment, compliance, and resistance. Commitment and compliance are more desirable outcomes than conflicts or resistance. If conflict or resistance is likely to occur, Hardy (1996) suggests that conflict and resistance can be overcome by mobilising power.

Hardy's work draws on and combines variations of the traditional power theories developed by Bass (1960), French and Raven (1959), and Clegg (1975). For Hardy (1996), power is multi-dimensional. She (1996) classifies power into four dimensions: power of resources, power of decision making, power of meaning, and power of systems.

#### 3.3.4.1 Power of Resources

The first dimension is power of resources. This type of power explains how actors use and restrict key resources to modify the behaviours of other actors. A manager can deploy resources to control or modify the behaviours of subordinates. This concept is related to task-orientation and involves "carrot and stick" persuasion and coercion. Specifically, Hardy (1996) claims that this type of power plays important roles when organisational actors depend on certain resources such as information, skills, political access or monetary rewards.

Consequently, issues of power and control in organisations are associated with rules, procedures, practice, and formal and less formal relations as well as accounting techniques and methodologies (Sisaye 1997). To avoid or minimise resistance of employees to change, the key organisational actors can manage the resources. This claim is consistent with other scholars. Bourgeois (1991) and Vecchio (1997) for example, believe that managers can force subordinates to obey their request as managers control key organisational resources.

#### 3.3.4.2 Power of Decision Making

The second dimension of power is power of decision making referring to the individual power to restrict or enable access to organisational decision-making (Hardy 1996). In the political choice model, decision making processes such as resource allocation and the design of accounting systems, are more a function of the on-going resolution of power struggles among coalitions and the influence of political processes, including dominant organisational ideologies as well as individual and group interest, than organisational economic objectives (Sisaye 1997). This type of power is exercised to influence subordinate participation in the process of decision-making. The exercise of this power can either motivate or diminish subordinate participation. This power comes from symbolic sources (hierarchy structure).

As decisions are reached through bargaining, compromise, and negotiation, politics becomes the predominant factor determining organisational decisions. Pfeffer and Salancik (1974, p. 139) argue that

> organizational decision making, particularly resource allocation decision making is a political process and can be explained by consideration of relative subunit power, as well as by consideration of possible bureaucratic criteria.

Accordingly power of decision-making can be mobilised to reduce conflict and to legitimate outcomes so that the symbols can be accepted in organisation (Hardy 1996).

#### 3.3.4.3 Power of Meaning (Symbols)

The third dimension of power is power of meaning. This type of power can influence perception, cognition, and preference of actors in order to make them accept the status quo or perceive that changes are intended, rational and legitimate (Hardy 1996). Bradsaw (1998) views this power as "deep-cultural power" of reality. If managers can use symbols and meaning to convey to subordinates that changes are legitimate, then resistance to changes will decrease (Hardy 1991). Within this perspective, those who are able to define organisational reality have considerable power over those accepting reality as their own (Bradsaw 1998; Hardy 1985)

#### 3.3.4.4 Power of Systems

The fourth dimension of power is power of system. This power is embedded in organisation systems in which every actor takes it for granted (Hardy 1996). Such power is far from the direct involvement of organisational members because this power exists in the unconscious acceptance of values, traditions, cultures and institutional structure and captures all actors within organisational networks (Hardy 1996). This dimension is the most difficult dimension to change as the dimension involves unspoken rules and norms of organisations that can motivate and provide stability to organisation activities (Boonstra and Bennebroek-Gravenhorst 1998; Burns and Scapen 2000).

Hardy (1996) believes that to make changes, managers need to mobilise all dimensions of power. Consequently, power over resources, decision-making, and meanings must be so effectively mobilised and targeted that the actors in making the process of change do not resist their own preference. Hardy (1996, p. 9) claims that:

> by managing meanings, managers can change underlying values and norms but, used alone, its inability to target specific behaviours will hinder effective strategic change.

Based on such arguments, changes will flow effectively when managers are able to develop integrated strategies by considering the three dimensions of power. Power mobilisation, for Hardy (1996, p. 10) involves "a coordinated approach that encompasses all three dimensions to influence actions, awareness and values, and avoid both inertia and confusion". In addition, Pettigrew and McNulty (1995) claim that power and influence of part-time board members[20] is shaped by the simultaneous and interactive effects of a set of structural contextual factors, positions and skills in mobilising a constellations of power sources; and skills as well as wills in converting potential power into actual influence.

[20] A part-time board is a board whose members hold multiple roles of either chairman and/or non-executive directors of the organization.

The concept of power as described by Hardy (1996), power mobilisation, helps to explain the dynamic of financial reporting practice. Although her work explains changes in the context of organisational strategies, her contribution can be used to explain complexity of financial reporting practice. Specifically, Hardy's (1996) concept is useful in explaining why and how an organisation is committed to a quality financial reporting practice.

As previously discussed, financial reporting practice is influenced by institutions and politics. Cognitive, normative and regulating structures and activities, as institutional theory posits, are carried into an organisation by a number of factors, including culture (Scott 1995). The dominant culture in a society exerts a pervasive influence on individual and corporate behaviour. The Indonesian people hold certain beliefs that influence their behaviour, which are based on Javanese culture, which has been dominant (Antlov 1994; Magnis-Suseno 1997; Mann 1996; Mulder 1994; Yudianti and Goodfellow 1997).

As culture is learned and derived by individuals from a social environment throughout their lifetime, Javanese culture is reflected in Indonesian social relationships, such as in workplaces, political organisations and other institutions, including financial reporting practice. The following section will briefly describe cultural and political environment from Javanese perspective that is perceived as relevant to this study

## 3.4 CULTURAL AND POLITICAL ENVIRONMENTS: JAVANESE PERSPECTIVE

Discussing Javanese culture is not easy, because it is so diverse and complex. Such a discussion could refer to language, way of life, ethics, performing arts, texts and more. This study focuses on the Javanese culture in terms of world-view, "the Javanese idea of the good life" as studied by Magnis-Suseno (1997).

### 3.4.1 Javanese Culture as Dominant Culture

The Javanese (who speak the Javanese language) are the original inhabitants of the central and eastern regions of Java Island (*Jawa Tengah* and *Jawa Timur*). The Javanese are numerically the largest ethnic group in Indonesia. Because of the sheer size of the community, the homogeneity of its culture and their influence on the nation's capital, Javanese culture influences the way of life of most Indonesians, and the Javanese dominate cultural, business, social and political activities in Indonesia (Mann 1996; Magnis-Suseno 1997). Two basic principles of Javanese social life, as discussed below, characterise such dominance.

#### 3.4.1.1 Two Basic Principles of Javanese Social Life

The Javanese have a complex code of etiquette and respect, reflected in the Javanese language. However, the maintenance of inner peace and harmony is a priority in social relationships among the Javanese. Indeed, maintenance of social harmony is the core value of Javanese culture. In relation to social harmony, the Javanese have the following beliefs (Mann 1996, p. 98):

1. the belief in a preordained cosmic order to which people can only submit
2. the belief that everyone has his or her place in society and knows what it is without having to be told
3. the belief that people should remain calm in the face of events and that interpersonal behaviour should be aimed at maintaining social calm and harmony.

Based on these beliefs, the social relationship of the Javanese is characterised by two basic principles reflecting their ideas of a good life. These principles (conflict avoidance and respect) are well described in the anthropological and sociological work of Magnis-Suseno (1997).

**a) *The Principle of Conflict Avoidance***

Javanese culture is characterised by the avoidance of all form of direct confrontation. Indeed, conflict avoidance plays a crucial role in maintaining social harmony. To avoid conflict, the Javanese are committed to the concept called as "*rukun*", which shows how people should interact in a social relationship. Mulder (1978, p. 39) has described *rukun* as follows:

> *Rukun* is soothing over of differences, cooperation, mutual acceptance, quietness of heart, and harmonious existence. The whole of society should be characterized by the spirit of *rukun*, but whereas its behavioural expression in relation to the supernatural and to superiors is respectful, polite, obedient, and distant, its expression in the community and among one's peers should be '*akrab*' (intimate) as in a family, cozy, and '*kangen*' (full of the feelings of belonging).

*Rukun* is characterised by cooperation, mutual acceptance, calm and unity (Magnis-Suseno 1997). To achieve *rukun*, individuals should be a part of the group and their individuality should be expressed through the group. Hence, all obvious expression of conflict that lead to disharmony should be avoided.

Magnis-Suseno (1997) claims that *rukun* is concerned with the attainment of outward harmony within society. Thus, Javanese society has norms of conduct, a rigid etiquette well known as "*tata krama*" involving gestures, the way of shaking hands, and content and forms of speech (Magnis-Suseno 1997). In short, the Javanese understand well that this *tata krama* regulates all direct interactions of individuals with members of a society according to their hierarchical positions, such as structural positions in government institutions, ages and educational levels. The use of Javanese language is an example of *tata krama* [21]. Social positions will determine how, when and why individuals use language in their social relationship.

As conflict avoidance plays an important role in the maintenance of social harmony, the Javanese have different ways of expressing disagreement. This includes walking away from trouble and the practice of not speaking with each other for a given period (known as "*jothakan"*). All these ways of expression of disagreement usually end with a formal mediation by a third party (Geertz 1961). However, the Javanese seldom show their expression of disagreement. Mann (1996) describes this as hypersensitivity and a major personality characteristic among Javanese. They attempt at all times to maintain harmony between and

[21] In Javanese language there are three level of language: one used by socially inferior individuals, one used by socially superior individuals, and one, the highest level, used only at royal court. The word "die" in Javanese language can be expressed as "*mati*" (used by ordinary people or used by superiors when speaking to inferiors), "*seda*" (used by inferiors when speaking to superiors), or "*mangkat*" (only used at royal court).

among individuals through extreme sensitivity to their own words and actions and to the words and actions of others. This conduct is closely related to the second principle of Javanese culture, the principle of respect as discussed in the following section.

***b) The Principle of Respect***

Another way to maintain social harmony is the implementation of the principle of respect. According to this principle, the Javanese, both in speech and behaviour, have to demonstrate "proper respect to those with whom one comes into social contact" (Magnis-Suseno 1997, p. 62). Similar to the principle of conflict avoidance, the use of language and gesture reflects how the Javanese extend their respect to other people in accordance with their social status (such as age and structural positions). Hence, individuals should know their positions and duties, and honour and respect those in higher positions, while remaining benevolent towards, and responsible for those in lower positions (Magnis-Suseno 1997).

The principle of respect signifies that individuals should not be ambitious in competing against others if such ambition can lead to social disharmony. To quote Mulder (1978, p.41), "ambition, competition, impoliteness, and personal wishes for material gain and power are sources of disruption, disharmony and contradiction that should be avoided and repressed". In short, in a social relationship, the Javanese must behave in accordance with the principle of respect for the maintenance of social harmony.

The principles of conflict avoidance and respect are manifested in the Javanese social life in terms of hierarchical position and collectivism. Such manifestation can be seen in the social relationship in the Indonesian environment, both in business organisations and government institutions.

#### 3.4.1.2 Hierarchical System: The Figure of "*Bapak*"

As mentioned in the previous section, social hierarchy has a crucial place in the social relationship among the Javanese. Indeed, Javanese culture demonstrates a very sophisticated hierarchical system, as reflected in the Javanese language (Marianto and Goodfellow 1997). Individuals must understand their positions, and accordingly they will speak and behave according to these.

The hierarchical structure is seen as a mechanism to exercise *rukun,* because it ties people together in personal bonds of unequal moral and material values. Within such a hierarchy, the Javanese rely on a leader for any crucial decisions. This leads to the existence of a father figure, well known in Indonesia as "*Bapakisme*". As Mulder (1994, p. 60) contends, "a leader is *Bapak*, a father and reliable patron who should be honoured and followed, whose whim and wish is a command, and who cares for his subjects (*anak buah*)". Therefore, those who are in the higher position must care, and the lower must obey and follow. In Mulder's (1994, p. 61) words, "subordinates should show their feelings of awe and love (*wedi-asih*) and the leader should sympathise (*tepa slira*) with the inferior". Consequently, individuals who go against their leaders, who are critical or go their own way, and who are ambitious and compete with their leader are considered "rebellious (*duraka; mbalelo*)" (Mulder 1994, p. 61).

Mulder's view is similar to that of other scholars. For example, Marianto and Goodfellow (1997, p. 29) remark that according to "*Bapakisme",* the Javanese culturally and socially interpret their world in a hierarchical fashion. They (1997, p. 30) continue: "many Indonesians who are lower down in the social hierarchy are afraid, or perhaps psychologically incapable, of taking personal initiatives, unless they first obtain direct permission from a superior". This behaviour can be seen in business and government organisations. Even though an individual may hold a degree from a Western university, their daily behaviour in social and business relationships is still influenced by this hierarchical position.

#### 3.4.1.3 Collectivism: *Gotong Royong* and *Musyawarah*

It is mentioned above that the core value of Javanese culture is maintenance of social harmony involving the exercise of *rukun*. However, it should also be noted that the concept of *rukun* does not mean that the Javanese have no individual interests (Magnis-Suseno 1997). Instead, within the concept of *rukun*, such interests are integrated into group welfare. This is because the Javanese prefer to seek the security and support of others. To quote Koentjaraningrat's (1957, p.458) work, the Javanese often use the following phrase to describe a social relationship in Javanese society: "If there is only little, each will receive little, but if there is much, each will receive a big share".

In such a social relationship, there is almost no room for individualism in the Javanese society. In other words, in spite of being individuals, the Javanese prefer collectivism. This view is based on a belief that social harmony can be threatened by individualism, diversity and conflict (Mulder 1994). As far as collectivism is concerned, it is common for the Javanese to "develop networks of acquaintance: workmates, customers, relatives, friends, neighbors and colleagues" (Yudianti and Goodfellow 1997, p. 104).

To exercise collectivism, individuals act both in social and in business activities based on the concept of "*gotong royong*" and "*musyawarah*". "*Gotong royong"* refers to a philosophy that says that people must help each other; whereas "*musyawarah*" refers to the fact that all decisions should be made only after a consensus or compromise has emerged (Magnis-Suseno 1997). The demand for collectivism that is supported by "*gotong royong*" and "*musyawarah*" is codified in a classical and well-known Javanese proverb: "*Sepi ing pamrih, rame ing gawe, mangayu ayuning bawana*—be disinterested, work hard, perfect the world" (Antlov 1994, p. 77).

Based on this brief description, the Javanese ideas of the good life can be summarised as follows:

1. Any individual conduct must be directed to the maintenance of social harmony.
2. Social harmony can be achieved when individuals avoid unnecessary conflicts and respect one another.

3. Individuals must know their positions and duties, honour those in higher positions and care and be responsible for those in lower positions.
4. Individualism is not seen as an important aspect in the social relationships and any efforts and interests must be performed through a collective approach involving cooperation and a consensus.

### 3.4.2 *Jawanisasi*: the Institutionalisation of Javanese Culture

Javanese culture influences social relationships among not only the indigenous Javanese, but also those who come from other ethnic groups. This occurs because of "*Jawanisasi"*—the institutionalisation of Javanese culture in all aspects of Indonesian life. Beside the dominance of the Javanese Kingdoms in the history of Indonesia, this institutionalisation was performed successfully in the era of New Order (1966–1998) led by the former president of Indonesia, Suharto[22]. During this era, Suharto positioned himself as a father of the state and assumed the state was a big family. To quote Mulder (1994, p. 62):

> By having brought in the hidden familial assumption (*kekeluargaan*—functioning a family), the functioning of the state as a big family with a father as its head becomes clear. A father of state protects and guides, the population submits and follows.

Furthermore, Liddle (1996) describes the role of Suharto in shaping a social and political relationship in Indonesia. He (1996, p. 17) argues that the

[22] It is stated in the history of Indonesia that the influential kingdoms in the formation of the state of Indonesia come from the Java Island, such as the Kingdom of *Mataram, Majapahit*, *Airlangga, Singasari and Padjajaran*. The only well-known kingdom that came from another island is the Kingdom of *Sriwijaya* in *Sumatra* Island.

relationship between personal rules and institutionalisation in the New Order era are as follows:

1. Institutionalisation has begun to replace personal rule in Indonesia.
2. What is being institutionalised is the "New Order Pyramid": a dominant presidency, a politically active armed forces, a decision making process centred in the bureaucracy, and a pattern of state–society relations that combines cooptation and responsiveness with repression.
3. The key promoter of institutionalisation in New Order politics is Suharto himself by designing policies that have created an identifiable pattern of political expectation, anchored in a powerful structure of interests, affecting present and future presidential, armed forces, and bureaucratic behaviour.

Such policies made *Jawanisasi* ubiquitous. *Jawanisasi* was performed through the behaviour of political actors who positioned themselves as the "untouchable leaders" (*bapakisme)* in a number of government institutions, through mass media that reported all activities containing the Javanese way of life, through the use of certain Javanese language as slogans, especially in educational activities[23], through a transmigration program[24], and through bureaucracy by positioning Javanese in strategic posts around the archipelago of Indonesia.

Consequently, those who do not really understand Javanese culture might conclude that Javanese are arrogant and want to dominate all activities in Indonesia. They might also conclude that Javanese culture is an intolerant culture.

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[23] In Indonesia there is a course named "*Pendidikan Moral Pancasila*" (Pancasila Moral Education) that must be learned by students from elementary to senior high schools. This course contained materials related to Javanese culture, especially how individuals interact with the community and the state. Consequently, in this course it is easy to find the Javanese concepts such as *gotong royong, rukun, musyawarah* and other Javanese terminology (For details see Mulder 1994).

[24] This program refers to a system of resettling inhabitants of overpopulated islands to less populated regions. However, as the Java Island is the most populated, people migrating to other islands are mostly from Java. Indeed, it is easy to find villages with Javanese names in other islands outside Java to show where the migrants come from. This has eventually made Javanese culture embedded in the new environment.

However, such conclusions are misleading. A negative image of Javanese culture is mainly caused by the behaviour of leaders and politicians in the New Order Era. However, they actually do not reflect Javanese culture because they act for the interests of their own groups (family) not for the interest of all Indonesian society. In other words, they misleadingly implemented Javanese culture for their vested interests. This is not a reflection of Javanese culture, because Javanese culture has ethical values that are helpful for creating inner peace and social harmony[25].

In relation to the extent to which Javanese culture has influenced business and government activities in Indonesia, it is fruitful to consider a study by Hofstede (1982). Using his four dimensions of culture, Hofstede (1982, pp.14–29) described the dimension of culture in Indonesia as follows:

1. In line with the dimension of individualism–collectivism, the Indonesian people are relatively more collectivist. This is characterised by the following conditions:
   a. relationships of superiors and subordinates is more moralistic and calculative
   b. employees have obligations to their families and relatives (nepotism)
   c. in a business contract, relationships between people are more important than their jobs
   d. there is a strong need for maintaining harmony and avoiding conflicts
   e. opinions are collectively predetermined.

[25] For a detailed analysis see Magnis-Suseno (1997).

2. For the dimension of power distance, Indonesian employees show a high score on power distance because there is inequality in the Indonesian social hierarchy. The model of Indonesian society is based on a social hierarchy according to position in the society. Thus, higher and lower positions are a common situation. Three characteristics of Indonesian power distance are: strong paternalism, the importance of differences in a status and position, and respect for older people.
3. In regard to conflict avoidance, the score of Indonesia for this dimension is high. This means that Indonesian people have a high tolerance for different opinions and behaviour. It is common for the Indonesian to make a compromise in regard to uncertain situations. Moreover, in Indonesia, people are relatively not emotional and reluctant to show their feelings. However, it should be noted that as the Indonesian prefers collectivism, it is possible for the Indonesian to show their emotions en masse, such as at a demonstration. Finally, for the Indonesian it is not hard to accept the relativism of truth.
4. In terms of the masculinity–femininity dimension, Indonesians are more inclined to femininity. They dislike ambition, competition and arrogance. However, Hofstede (1982) did not clearly interpret this dimension.

This study by Hofstede (1982) shows that in general Javanese culture has influenced the Indonesian business and governmental activities. This also means that Javanese culture influences the organisational culture of a company. Maclagan (1998, p. 130) maintained that “plainly one cannot treat organizations in isolation, unaffected by wider value or public pressures. People import societal values into the organisation...” However, it should be noted that the adoption of Javanese culture into organisational culture does not occur automatically. It depends on how the organisational players see the importance and relevance of such culture to their companies. This means that an actor plays an important role in exercising power to shape the behaviour of organisational members and to construct financial reporting practice.

### 3.4.3 Power And Leadership: A Javanese View

As discussed in previous section, this study affirms that power exists because of a social interaction among individuals. Power is characterised by relationships among social actors in an organisation, and between these individuals and other external constituents. Within such relationships, a certain social actor has more power with respect to some social actors, and less power with respect to others. Different people can bring different perceptions and different interpretations to each situation. Consequently, the perception of influenced individuals on the capabilities of influencing actors in mobilising power will determine whether an individual is powerful or powerless.

To help understand how powerful actors in *Bintang* influence other organisational members to be committed to quality financial reporting practice, the following section will discuss the concept of power and leadership in light of Javanese culture.

### 3.4.3.1 Javanese Philosophy on Power[26]

Discussion of power within the Javanese context is interesting because the concept of power in Javanese culture is different from that in Western thought. It is common in Western thought that power is seen as something abstract, and only becomes concrete when an individual is able to influence another. On the contrary, within Javanese philosophy, power is something substantial, and it is understood from a mystical-supernatural point of view, and is related to a pattern of order (Anderson 1990; Anderson 1972; Moedjanto 1990). Indeed, Magnis-Suseno (1997, p. 101) argues that:

> …[p]ower covers all forces in nature and is an outflow of the invisible, continually creative, divine energy that permeates the whole cosmos. Power...is an expression of cosmic power which can best be understood as a kind of fluid force which permeates the entire universe.

Based on this definition, within the Javanese perspective, an individual is seen as powerful because of their cosmic strength. This individual is viewed as the so-called "*sekti*", or supernaturally strong, and the power that makes them *sekti* is labelled "*kesakten"* (Magnis-Suseno 1997, p. 102).

In Javanese literature, such a view of power is traditionally associated with the existence of a king or a ruler. An individual is seen as powerful if they have monopoly of power and are able to create a condition in which peace and prosperity flow across the territory under their control (Magnis-Suseno 1997). As

[26] For a detailed discussion on this topic see Anderson (1972; 1990), Moedjanto (1990) and Magnis-Suseno (1997).

long as the king or ruler is able to create order, their dynasty will continue to flow. Goodfellow (1997, pp. 21–22) points out that:

> …[i]n a traditional sense, power [in a Javanese context] is defined by *priyayi*[27] as adherence to an established pattern of order. Life is interpreted as a cosmological oscillation between periods of concentration of central power and periods in which that power ebbs away...This pattern on power, or lack of power, is characterized by epochs of either order or disorder. Power begins to ebb away from the center of power, the reigning dynasty loses its claim to rule, and disorder appears until a new ruler reverses the process. As power becomes concentrated and order is re-established, a new dynasty is created.

Such a view of power implies that power is exercised in a different way from Western thought. For the Javanese, a ruler or a king is seen as powerless if they exercise power in a coercive way (Anderson 1990; Antlov and Cederroth 1994). Power should be executed through soft commands and exemplary behaviour. Through these ways of exercising power, the king or ruler will be able to mobilise their power. In the Javanese society, there is a belief that calmness connotes an existence of inner strengths, and that showing an authority by outward efforts indirectly exhibits weaknesses of the ruler (Magnis-Suseno 1997). Furthermore, Keeler (1985) argued that:

> ...leader's power in Java depends...on how well he [the leader] fulfils the idealized image of the exemplary centre: a spiritually powerful, alluring and benevolent leader. Power should be executed through *perintah halus* (gentle hints) and not by direct commands (cited by Antlov and Cederroth 1994, p. 13).

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[27] *Priyayi* is a Javanese aristocrat that mostly existed during the Dutch colonial period. They received any education in administration and management practice, and this was applied mainly in government education (Marsh and Goodfellow 1997). However, this view on *priyayi* in the Javanese society still exists in the present day.

Consequently, an individual who becomes a ruler and misuses their position of power to indulge personal pleasure though coercive commands and behaves in a tyrannical manner will fail in maintaining his dynasty (Magnis-Suseno 1997).

The Javanese concept of power that is constructed on a supernatural point of view might be irrelevant for discussing power in the milieu of a modern organisation. This is because in contemporary organisations, individuals must search, create and exercise power to influence others (Hardy 1996; Mintzberg 1983; Pfeffer 1981; 1992). Nevertheless, because a social relationship in the sense of Javanese culture is based on a hierarchical model, the concept of power within the framework of a social interaction, such as a concept of power by French and Raven (1959), is seen as relevant for this study. Hence, in this study, as pointed out in the previous section (3.3.2), power is defined as the ability of one actor (A), in a social relationship of organisations, to successfully influence the behaviour of another individual (B), by which the ability of actor (A) in influencing depends on the perception of another individual (B) on the ability of actor A in mobilising sources of power in the relationship.

The definition implies that within an organisation, the exercise of power is associated with leadership because in mobilising power, outcomes of an influence are largely dependent on a leadership style. In fact, the abilities of a leader in influencing organisational members might result in commitment, compliance or resistance (Yukl 1989). As such, the following section will explicate the concept of leadership in light of Javanese culture, which is perceived as relevant in understanding the dynamics of financial reporting practice in *Bintang*.

#### 3.4.3.2 Leadership: *Tri Pakarti Utama*

In Javanese culture, a leadership model might be different from that of a Western view. Indeed, the Javanese leadership model is built on a hierarchical system wherein a leader is seen as a figure of *Bapak*-father, who behaves according to Javanese etiquette. According to Widyahartono (1991) and Yudianti and Goodfellow (1997), the characteristic of the Javanese leadership model can be related to the ideas of Ki Hajar Dewantoro, an Indonesian national hero who is also popular as the founder of the Indonesian educational system. His concept is known as "*Tri Pakarti Utama"*—three pre-eminent attitudes. According to Ki Hajar Dewantoro, an Indonesian leader should posses the following characteristics:

*Ing Ngarso Sung Tulodo*
*Ing Madyo Mangun Karso*
*Tut Wuri Handayani*

*Ing ngarso sung tulodo* means that leaders should be a good example for their subordinates through their positive attitudes, wise words and exemplary behaviours (Widyahartono 1991; Yudianti and Goodfellow 1997). Leaders should be able to develop themselves by altering their attitudes, behaviour and daily life to become exemplary models for their subordinates. Subordinates will perform ethically if they see that their leaders show ethical conduct. Hence, a corrupt leader will result in a corrupt organisation because all individuals in the organisation copy the leader's behaviour.

*Ing madyo mangun karso* means that leaders should be disciplined, independent and creative in their relationships with subordinates (Widyahartono 1991; Yudianti and Goodfellow 1997). Thus, a leader should have abilities to motivate and build a spirit of innovation, self-help and creativity in subordinates. In today's organisational setting, this characteristic refers to an ability of a leader to empower their subordinates to achieve a targeted outcome.

*Tut wuri handayani* means leaders should be known by their achievements and their sense of responsibility towards their subordinates. (Widyahartono 1991; Yudianti and Goodfellow 1997). Consequently, a leader must have abilities to persuade their subordinates and be brave enough to become forerunners in bearing responsibilities.

Furthermore, because the Javanese focus their attentions on maintenance of social harmony, leaders will focus on collectivism in making a decision. In fact, as Marsh and Goodfellow (1997) emphasise, two important concepts about leadership and the decision making process are *musyawarah* (mutual deliberation) and *mufakat* (the common unanimous decision). These two concepts must be considered when a leader is making a decision because the outcomes of decision—making are ultimately for *kepentingan bersama*—public interests/benefits (Magnis-Suseno 1997). Marsh and Goodfellow (1997, p. 145) justify that for the Javanese, "the good leader will always engage in mutual deliberation or consensus-seeking in an attempt to reach *mufakat*, guided by *rukun* or desire to social harmony". This denotes that individuals should subordinate their own interests for the benefits of the community welfare.

Apropos of such a view on leadership, it is believed that a leader will never use coercive power to influence others. Marsh and Goodfellow (1997, p. 145) maintain that:

> …[t]he ideal of operation of power in Javanese culture is never explicit; it is a weak leader who relies on direct forces or coercion. The good leader is always "*halus"* (means smoothness of spirit, self-control, beauty, elegance, politeness and sensitivity*)*, calm and serene, never expressing strong emotions outwardly, and is able to mould events to his or her will with a minimum of apparent effort. Another important Javanese concept is that of "*tepa-slira"*, or the ability of a superior to sympathize with, and understand, the position of the subordinates.

Similarly, Antlov (1994) contends that in Javanese culture, leaders are sensitive to the demands of their subordinates, and people answer with obedience and submission.

The above arguments imply that in the Javanese society, the head of a company, as a leader, is seen as a figure of *Bapak*-father. Employees come to them with issues and problems of a more personal nature. This is because a Javanese leader is open to negotiation and consensus and is willing to see things from the other party's point of view, even though it relates to personal issues (Magnis-Suseno 1997; Yudianti and Goodfellow 1997). For a certain scholar, *bapakisme* might be seen as a type of non-participatory management. For example, Marsh and Goodfellow (1997, p.  146) claimed that:

> …[i]n general Indonesian managers follow the pattern of a 'benevolent authoritative' management style that is open to consultation, but definitely not democratic or participatory.

Nevertheless, if an individual, as a leader, behaves in accordance with the Javanese view on ethical social relationships, as discussed in the previous section, such a leadership style is perceived useful to manage a company for maintaining social harmony. *Bintang,* as will discussed in Chapter Eight, is an example of this view.

## 3.5 CONCLUSION

This chapter discussed institutional theory and power mobilisation as a theoretical lens of understanding financial reporting practice in a company. Based on a number of reasons as discussed at the beginning of this chapter, it is claimed that institutional theory suffices to explain why and how a company commits to quality financial reporting practice. Institutional theory is able to explain why a certain company adjust its organisational structures and practices to respond to external institutional pressures. Three mechanisms (coercive, normative and mimetic isomorphism) are processes by which an organisation conforms to the external institutional pressures to gain support and legitimacy from a society in which the organisation's activities take place.

This chapter also discussed how powerful actors within the organisation, are seen as important in managing an organisation to respond to external pressures. This actor will also play a role in shaping an organisational reality and in influencing organisational members to commit to quality financial reporting practise. Such an actor will determine beliefs, values, and norms that are perceived as relevant for the organisation and constrain behaviour of other organisational members. This means that power and leadership are issues, which should not be neglected in discussing the dynamics of financial reporting practice.

It was also discussed that financial reporting practice is influenced by cultural and political environment in which such practice takes place. In the Indonesian milieu, organisational behaviour, to some extent is determined by Javanese culture. Indeed, through *Jawanisasi*, Javanese culture—as the dominant culture in the society—exerts a pervasive influence on individual and corporate behaviour. Javanese views of an ethical social relationship are perceived as useful to understand financial reporting practice in the company being observed.

Hence, this study employed a theory-triangulation approach involving institutional theory, power mobilisation by Hardy (1996), and Javanese culture as a lens of understanding financial reporting practice within an organisational setting. The next chapter will discuss a theoretical framework and a research method to help understand how this study was undertaken to answer research questions as explicated in Chapter One.

# CHAPTER FOUR
# INTEGRATED THEORETICAL FRAMEWORK AND RESEARCH METHOD

## 4.1 INTRODUCTION

As mentioned in Chapter One, this study is intended to understand why and how a company is committed to quality financial reporting practice. To understand the dynamics of financial reporting practice, an integrated theoretical framework is required. Baiman (1990) and Stake (2000) suggest that a conceptual framework helps the researcher to direct and sharpen the focus of inquiry. Institutional theory and power mobilisation, as discussed in Chapter Three, are perceived as providing a valuable theoretical lens for understanding financial reporting practices in an organisational setting. In addition, based on research questions and objectives, as well as a belief that financial reporting practice is a socially constructed reality, this study adopted an interpretative approach.

This chapter will explain an integrated theoretical framework and the research approach adopted in this study. The first section will describe an integrated framework for understanding the dynamics of financial reporting practice. The following section will explain the research approach employed in the study.

## 4.2 INTEGRATED THEORETICAL FRAMEWORK

This study claims that ontologically, financial reporting is an institutional and political practice involving external forces and individuals' behaviour. Financial reporting is a socially constructed reality that can shape, and be shaped by, powerful actors and institutional environments. Thus, the framework is developed using institutional theory and power politics theory. Figure 4.1 illustrates a model of financial reporting practice to address two questions: why an organisation issues quality financial reports and how external pressures and an organisation's internal dynamics shapes actors' behaviour in producing such reports.

**Figure 4.1 Model of Financial Reporting Practice: Institutional and Political Perspectives**

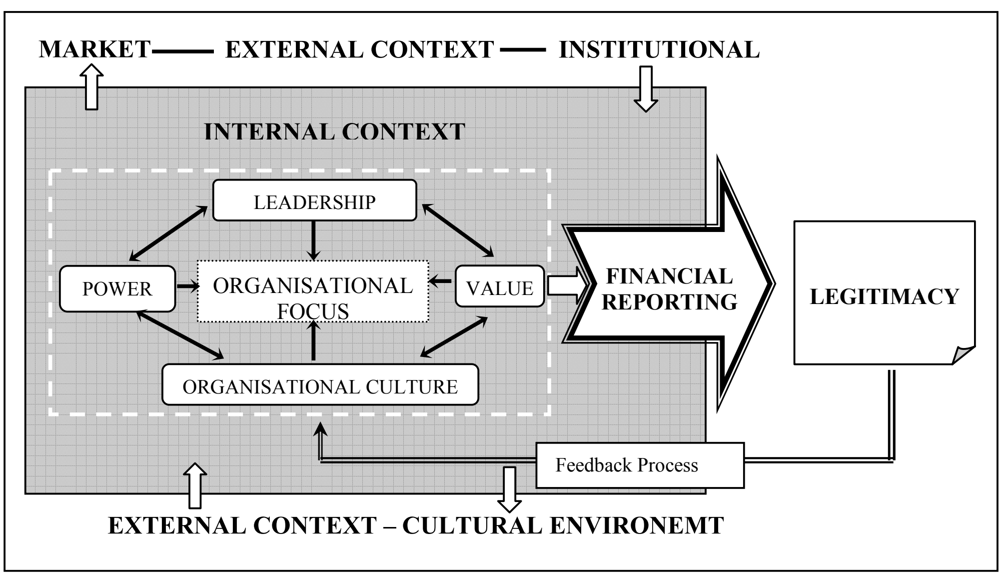


Figure 4.1 is explained below.

### 4.2.1 Legitimacy as a Reason

Figure 4.1 reveals that organisational activities never take place in a vacuum. Instead, institutional, political, and cultural environments can shape and be shaped by an organisation. External pressures and organisation's internal dynamics will determine how an organisation should behave in its environmental context.

There might be many reasons why a company exists and survives in a rapidly changing business environment. However, obtaining legitimacy is important for a company because it demonstrates social worthiness and mobilises resources (Oliver 1991). Because an organisation consumes resources that have alternative uses, society tends to evaluate the usefulness and legitimacy of the organisation's activities (Meyer and Scott 1983; Deegan 2001; Dowling and Pfeffer 1975; Parsons 1956).

Schuman (1995, p. 574), in his comprehensive review of the relevant literature, defines legitimacy as

> ...a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values and definition.

This definition considers an evaluative and cognitive dimension of legitimacy and acknowledges the role of a social audience in the legitimation process. Accordingly, the legitimation process can be seen as an inherently collective social process that "...mediates the relationship between power and authority and affects the establishment, persistence and change of social organizational forms"

(Berger, et al. 1998, p. 379). This means that actors create and recreate a social reality through a collective process. In the context of an interaction between organisations and their society, Deegan (2001, p. 253) posits that

> organizations continually seek to ensure that they operate within the bounds and norms of their respective societies, that is, they attempt to ensure that their activities are perceived by outside parties as being legitimate.

Carruthers (1995, p. 324) also claims that "organizations are not only granted legitimacy; sometimes they go out and get it". In so doing, the organisation can employ certain means or strategies. For Ashforth and Gibbs (1990), there are two general means by which organisations seek legitimacy: substantive management and symbolic management.

Substantive management plays a crucial role in supporting an organisation in gaining legitimacy. It involves real and material changes in organisational goals, structures and processes. An example of this is that the organisation may seek legitimacy through "coercive isomorphism" (DiMaggio and Powell 1983). This is done through conformity to the values, norms and expectations of stakeholders on which it depends for critical resources.

On the other hand, within symbolic management, it is claimed that rather than actually change its organisational goals, structures and practices, the organisation may symbolically manage them so as to appear consistent with social values and expectations. This can be seen from the fact that the organisation espouses socially acceptable goals, but actually pursues less acceptable ones. Thus, for Carruthers (1995, p. 315), the adoption of a certain formal structure is more concerned with "the presentation of organizational-self than with how things actually transpire within the organization", and is "a kind of symbolic window dressing" for the organisational survival.

While substantive management may be associated with an institutional perspective, symbolic management is largely within a strategic domain of an organisation. Oliver (1991), Dowling and Pfeffer (1975) and Lindblom (1994), as discussed in Chapter Three, offer a number of strategies available for an organisation to respond to external pressures, and these range from conforming to manipulating. An organisation can implement these strategies either individually or in combination. Providing information through a financial reporting mechanism is a medium for an organisation to respond to environmental pressures and eventually to gain legitimacy (Chapter Six will elaborate on this).

### 4.2.2 Financial Reporting as a Medium of Legitimacy

As a socially constructed reality, organisational actors can construct financial reporting so as to gain legitimacy and show that their organisation operates in accordance with socially acceptable beliefs, values and norms. Items and information presented and disclosed in annual reports can be seen as a symbol and a rhetorical story of the company's activities. Hurst (1970) argues that one of the functions of accounting, including corporate financial reports, is to legitimate the existence of the corporation. The role of corporate financial reporting is to inform a society that an organisation's actions are accountable, and that they conform to social values and norms. In addition, Bowman (1978, p. 64) contends that annual reports are said to "reveal a great deal more about corporate strategy than most managers realize".

If today's financial reports are compared with those of previous decades, it can be seen that contemporary reports are more professionally made, provide more information (narrative texts) and their presentation is more interesting, with colourful graphs and diagrams. This might be intended to attract stakeholders for the purpose of gaining legitimacy. This means that in addition to disclosing factual information, the annual report can play a role as a crucial function of public relations to build a company's image (Chapter Six will discuss this issue further). Using terminologies by Hines (1988) and Neimark (1992), financial statements represent what is probably the most important document in terms of a company's construction of its own social image. Coy and Pratt (1998) also remark that financial reporting has an important role in communicating and shaping the reality of an organisation in public's perception. Narrative texts included in annual reports are an example of how a company builds its image for gaining legitimacy from its constituents.

As financial reports play an important role in describing organisational reality, companies are careful and serious in preparing financial statements. This is because financial reports are not only read by shareholders, but are also carefully analysed by other stakeholders. Consequently, it is reasonable to posit that manipulation of annual reports is an important part of the legitimation process (Dowling and Pfeffer 1975; Lindblom 1994).

Patten (1992) argues that disclosure of information by companies can be viewed as a company's method in reply to the changing perceptions of the public. This strategy refers to symbolic management (Ashforth and Gibbs 1990). For instance, researchers have found evidence of "self-serving attributions"[28] in annual reports (Aerts 1994; 2005; Bettman and Weitz 1983; Salancik and Meindl 1984; Staw, et al. 1983). However, it should be noted that how a company responds to environmental changes and pressures is also dependent on its organisational culture and powerful actors.

### 4.2.3 The Role of Ethical Organisational Culture

Organisational culture plays an important role in shaping financial reporting practice. Beliefs, values and norms, which are institutionalised and embedded in an organisation, will significantly determine individuals' behaviour. Johnson (2004, p. 3) notes that norms, values, beliefs, practices and procedures are valid if they observably govern the behaviour of actors in an organisation. A company is seen as a dominant institution where human behaviour and characters are "moulded through an external inculculation of supporting values and beliefs" (Dugger 1988, p. 101). These values are internalised by individuals, as part of their function as internal actors, to become a part of organisational culture (Baligh 1994).

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[28] According to Aerts (1994; 2005) "self-serving attributions" refers to a robust tendency to attribute positive outcomes to the company's own actions (company strategies, decisions, human resources, and so on) and negative outcomes to external events (business climate, government regulations, political condition, and so on).

By using institutional theory as a lens for understanding the dynamics of financial reporting practice, it can be argued that certain practices, methods and structures concerning financial reporting and the behaviour of organisational actors to some extent are determined by the values, cultures, norms and beliefs held by the particular organisation (Meyer and Rowan 1977). This view implies that organisational culture and accounting practice can be constructed to drive organisational members to commit to quality financial reporting practice. Accordingly, it is apparent that an ethical organisational culture and behaviour of organisational members can lead to ethical financial reporting practice. As Oliver (2004, p. 31) suggests, to be a truly transparent organisation, a culture dedicated to openness and a commitment to transparency from an organisation's most senior leadership is needed. This signifies that to create such a culture, an organisation needs powerful actors who are able to shape an organisation's reality and drive its members to commit to quality financial reporting.

### 4.2.4 The Need for Powerful Actors

The need for recognising the involvement of people in financial reporting processes and accounting processes and other organisational activities was discussed by Hopwood (1974). Hopwood (1974) claims that an accounting function is influenced by the needs and behaviour of individuals involved in the organisation, and by a process and pressure of other groups coming from a variety of social and economic environments. Social factors can determine individual behaviour as much as organisational rules. Mitroff (1983) also agrees with the involvement of people in the financial reporting process.

As an organisation can be seen as complex and individualistic, comprising a number of interacting interests and different people, actors in the organisation can plan, control and manage business as well as interact with one another. Every actor can shape, and be shaped, by institutional environments. Kotter and Heskett (1992) identify four factors shaping individual behaviour:

(a) competitive and regulatory environment
(b) leadership and its efforts to articulate and implement a business vision and strategy
(c) the formal structure, systems, plans and policies of the organisation
(d) corporate culture.

The involvement of powerful actors illustrates that organisational responses to external pressures for the purpose of gaining legitimacy does not occur automatically, but the responses are stimulated by how the political actors appreciate the existing factors, such as legal requirements, changing stakeholder expectations and threat to organisational legitimacy (Hardy 1996; Meyer and Scott 1983; Oliver 1991; Scott 1995; 1998).

In relation to financial reporting practice, accordingly, how organisational actors respond to external pressures mostly depends on the interplay of intra-organisational dynamics, such as power, politics, culture, interest, value and leadership. Clegg (1979) argues that institutionalisation of organisational rules and routines reflects the power of the organisational actor's translation and use of social expectations. Because various powers and conflicts of interest within the organisation determine how the organisation responds to institutional pressures, political actors or leaders within the organisation must be able to interpret the pressures and mobilise power to control and influence the organisational response (Finstad 1998; Jepperson 1991).

Moreover, institutional theory remarks that the existing norms, beliefs and values can act as resistance to new behaviours and ways of structuring organisational activities (Selznick 1957). To overcome such conflict and resistance, an organisation needs a leader who is able to define an organisational reality that is well understood by its members. Organisational leaders can also give priority to managing the environmental characteristics of their organisations (Sisaye 1997). The use of the theory of power mobilisation by Hardy (1996) is perceived as beneficial in understanding how power is mobilised by a leader to facilitate and institutionalise new strategies or culture in financial reporting practice.

Finally, it should be noted that because social norms and values are not immutable, the framework shows that financial reporting practice is a dynamic process that is vulnerable to external and internal forces. Accordingly, any changes in the institutional environments that might influence the organisational legitimacy will drive the organisation to reconsider its financial reporting practice. The feedback process as described in Figure 4.1 shows how every change that affects the organisational legitimacy will directly force the organisation to pay attention to current financial reporting practices.

To sum up, the above theoretical framework derived from the perspectives outlined in this chapter is a useful guide to focus the analysis of findings. The use of combined theories will enable the researcher to build a wider and more detailed explanation of the phenomena being studied (Ansari and Euske 1987).

## 4.3 RESEARCH METHOD

### 4.3.1 Research Approach

Several research approaches or methods are currently available to help researchers analyse phenomena, but these can be categorised into two main types: scientific research and naturalistic research (Holmes, et al. 1991). The first approach is well known as the mainstream or positivistic approach; but the second has been variously labelled as critical, interpretive and so on, according to the different characteristics in approaches and methods (Bernard 1994; Denzin and Lincoln 1998; Guba and Lincoln 1998; Lincoln and Guba 1986). The differences between scientific research and naturalistic approaches can be traced further into their ontology, epistemology and methodology. However, it is not within the scope of this study to discuss the differences.

This study is based on the understanding that reality exists as a social product and as a result of human interaction, symbolic discourse and creativity (Burrel and Morgan 1979; Denzin 1983; Hopper and Powell 1985; Morgan 1980; 1988; Tomkin and Groves 1983). Furthermore, it assumes that humans are incapable of total objectivity because they are situated in a reality constructed by subjective experience (Berger and Luckmann 1984). Meanings and the search for the truth is possible only through social interactions (Streubert and Carpenter 1999). Consequently, it is necessary to consider a wide social environment in order to understand a phenomenon (Bryman 1989). Cooper and Sherer (1984) shared a view with Burchell, et al. (1980) and Tinker (1980) which is that to design better accounting systems, we need to understand how accounting systems operate in their social, political and economic contexts. Failure to take such context into account has led to an emphasis on designing accounting reports that are in "the interests of shareholders", and not necessarily in "the interests of other groups in society" (Cooper and Sherer 1984, p. 224)

As previously discussed, this study argues that financial reporting practice is an institutional and political practice concerning the supply of information of a certain entity. Because actors can shape, and be shaped, by the environment, financial reporting practice can be viewed as a reality that is socially constructed and subject to political, economic and social pressures. By considering the social and political context, Cooper and Sherer (1984, p. 225) suggested that accounting research should

> *be explicitly normative*—make your value judgment explicit; *be descriptive*—describe and interpret the practice of accounting, accounting in action; and *be critical*—recognise the contested nature of the accounting problematic and particularly the concept of the public interest [original emphasis].

Therefore, to understand why and how a company is committed to quality financial reporting practice, an appropriate research approach is needed. The inability quantitatively to measure some phenomena has led to intense interest in using other approaches to particularly human phenomena. Based on the coherence between ontology, epistemology and human nature assumptions, this study has been designed with an interpretive method of inquiry. Nahapiet (1988) claims that from an interpretative approach, the process by which meanings that people attach to their social world are created and sustained are the central focus of understanding social action.

The interpretative approach is appropriate for this study because it enables the researcher to understand how financial reporting is practised in an organisation by considering values, beliefs, norms and structures accepted by organisational members, and by considering external factors, which are viewed as influencing financial reporting practice. This means that all human behaviours are shaped in the context of organisational culture (Dey 2001). In addition, such an approach is used because the aspect of human values, culture and relationships are unable to be described fully using quantitative research methods. In common with Boland and Pondy (1983, p. 225), the research objective "is not to study accounting *per se*, but to study individuals acting in organisations as they make and interpret accounts". Financial reporting practice can only be developed by reference to a particular setting in which it is embedded (Burchell, et al. 1980; Hopwood 1983; Miller 1994). Thus, this research is qualitative, and will employ a combination of two research methods: case study and ethnography. Both methods share a paradigm called interpretivism (Burrell and Morgan 1979; Guba and Lincoln 1989), and are situated within subjective epistemology (Guba and Lincoln 1998).

### 4.3.2 The Case Study: an Ethnographic Approach.

The research was guided by a desire to develop an understanding of the way people communicate, behave and act in their everyday life so as to construct financial reporting practice. Following a view by Hopwood (1983), such research must focus on financial reporting practice in its organisational setting and consequently employ a case study method. Based on this as a research method, Yin (2003, pp.13-14) defines a case study as an empirical inquiry that

> [1] investigates a contemporary phenomena within its real-life context, when [2] the boundaries between phenomenon and context are not clearly evident...[3] copes with the technically distinctive situation in which there will be many more variables of interest than data point...[4]) relies on multiple sources of evidence, with data needing to converge in a triangulation fashion...[5] benefits from the prior development of theoretical propositions to guide data collection and analysis.

With respect to research questions addressed in a study, Yin (2003, p. 1) suggests that "case studies are the preferred strategy when 'how' or 'why' questions are being posed..." In addition, a case study method is suitable when exploring "social processes as they unfold in organizations", and are also useful when the intention is not the study of organisational typicality, but unusualness (Hartley 1994, p. 211). It also provides a deeper understanding (Geertz 1973), a fuller contextual sense of the studied phenomena (Miles 1979) and a foundation for theory development (Van Maanen 1979a; 1979b).

Therefore, a case study is the proper research method for this study. The study is directed to understand "why" and "how" a company commits to quality financial reporting by describing and interpreting a particularly contemporary social phenomenon in its real-life context through the use of multiple theories and evidence. This study agrees with Smircich's view (1983b, p. 62), that a study within an organisational setting should be "concerned with learning the consensus meanings ascribed by a group of people to their experience and articulating the thematic relationship expressed in the meaning systems". Such a view signifies that an appropriate means of organising such approach is the case study approach.

In addition, the study presented here adopts an ethnographic approach as its focus. This is because it is built on a belief that a financial reporting practice is a socially constructed reality involving interaction among individuals, and between individuals and their institutional, political, and cultural environments. Consequently, as Creswell (1998, p. 58) suggests, it needs observation of a cultural or social group or system

> …through participant observation in which the researcher is immersed in the day-to-day lives of the people or through one-on-one interviews with members of the group...[to] study the meanings of behaviour, language, and interactions of the culture-sharing group.

This is because all human behaviour is shaped in the context of the organisational culture (Van Maanen 1979b) and "ethnography is the work of describing culture" (Spradley 1980, p. 3).

In a similar vein, Agar (1986) and Bernard (1994) claim that ethnography is a description of the patterns of behaviours of individuals and groups of people within a particular culture. However, ethnography is not merely a matter of studying people, rather it is more concerned with "learning from people" (Spradley 1980, p. 3). One of the purposes of ethnography is to make something *implicit* within a culture *explicit*. Cultural knowledge entails an understanding of people, including what they do, what they believe, what they say, how they interact with each other, and how they derive meanings from their own culture (Goetz and LeCompte 1984; Spradley 1980). Thus, ethnography helps us to understand human behaviour because individuals' behaviour reflects the meanings embedded in their culture and ethnography is a way to discover and understand those meanings (Spradley 1980). With this purpose in mind, there are a number of social, cultural and political aspects of financial reporting practice that need to be determined, including why organisations comply with regulations and why and how they are committed to quality financial reporting.

Despite the usefulness of ethnography, there has been a long-standing debate about what it actually constitutes. It is believed that particular practice of ethnography depends on the researcher's beliefs, the purpose of their research, the organisational setting and other contextual factors. To quote Muecke (1994, p. 188), "there is not a single standard form of ethnography". In addition, Boyle (1994, p. 182) points out that "the style and method of ethnography are a function of the ethnographer, who brings her or his own scientific tradition, training, and socialisation to the research project". Accordingly, it depends on the research purpose at hand.

This study argues that financial reporting is an institutional and political practice concerning the supply of information. It is a dynamic process operating in a political arena, involving a number of actors, rules, values, interests, and norms. This study intends to understand the dynamics of financial reporting practice by learning from what people actually do in regard to financial reporting. Analyses of the inferences and implications found in behaviour within a particular cultural setting (corporations) should enable the researcher to understand the dynamics of financial reporting practice in a company. Thus, this study used interpretive ethnography.

### 4.3.3 Procedures for Maintaining Credibility of Research

In order to contribute to knowledge, research must be scholarly rigorous. Hence, all research, whatever their design or approach, must consider the issue of rigour (Creswell and Miller 2000). Problems with qualitative research usually concern the credibility of research findings. This arises because of inabilities of the researcher to maintain independence and remain neutral in the research setting (Ryan, et al. 1992), and because a case study is extremely messy and highly interpretive (Allan 1991).

To maintain the credibility of qualitative research, a number of procedures can be adopted. Creswell and Miller (2000) proposed nine procedures to determine validity in qualitative inquiry, and suggested that these procedures are not exhaustive, but include several that are commonly used and cited in qualitative literature. The procedures consist of: triangulation, disconfirming, evidence, research reflexivity, member checking, prolonged engagement in the field, collaboration, the audit trail, thick and rich description, and peer debriefing (Cresswell and Miller 2000, pp.126–129). However, it is beyond the scope of this study to discuss all the procedures here. Instead, this study adopted appropriate procedures as suggested by Cresswell and Miller (2000), which might maintain the credibility of the study. This study utilised two procedures: triangulation and prolonged engagement in the field.

Apropos of the use of a triangulation approach, Cresswell and Miller (2000, p. 126) argue that triangulation is "a validity procedure where researchers search for convergence among multiple and different sources of information to form themes or categories in a study". Denzin and Lincoln (1998, p. 3) also maintain that

> [q]ualitative research involves the studied use and collection of a variety of empirical material-case study, personal experience, introspective, life story, interview, observational, historical, interactional, and visual text—that describe routine and problematic moments and meanings in individuals' lives. Accordingly, qualitative researchers deploy a wide range of interconnected methods, hoping always to get a better fix on the subject matter at hand.

Within this approach, Denzin (1978) suggests that to keep the information consistent, the validity of qualitative research can be maintained by employing multiple data sources (for example, participants), theories (such as organisational, political and sociological theories), and data collecting methods (interview, observation and examination of records), and the employment of different investigators. The use of triangulation will also reduce the possibilities of misinterpretations (Stake 2000), provide a comprehensive explanation of accounts and actions (Seale 1999) and improve the quality of research (Denscombe 1998).

Consequently, to achieve an effective study of an organisational context, this study shares a view with Smircich (1983b, p. 162–163), who suggests that "three forms of evidence may be used: observation, reports from informants, and the researcher's participation in the setting". This study employed methods of data collection as recommended by Smircich (1983), and utilised multiple theories as suggested by Ansari and Euske (1987), which are adopted from sociological and organisational studies.

The second procedure adopted by this study to maintain validity of findings was a prolonged engagement in the field. Fetterman (1989, p. 46) remarked that "working with people day in and day out for long periods of time is what gives ethnographic research its validity and vitality". Creswell and Miller (2000) also suggested that the researcher should spend a prolonged period in the field to produce credible findings. Through prolonged engagement in the field, the researcher can maximise the ability "to grasp motives, beliefs, concerns, interest, unconscious behaviours and the likes" (Guba 1981, p. 193). McKinnon (1988) suggested that such engagement can overcome difficulties in data access restrictions. Prolonged engagement enables the researcher to "build trust with participants, find gatekeepers to allow access to people and sites, establish rapport so that participants are comfortable disclosing information, and reciprocate by giving back to people being studied" (Creswell and Miller 2000, p. 128). Thus, prolonged engagement enables the researcher to check and compare data using a variety of different sources. This should eventually provide more detailed portraits of financial reporting practice being studied and therefore result in more credible findings.

### 4.3.4 Method of Data Collection

Streubert and Carpenter (1999) claim that there are at least six characteristics of ethnographic research:

(a) research as instrument

(b) fieldwork

(c) the cyclic nature of data collection and analysis

(d) focus of culture

(e) culture immersion

(f) tension between researcher as researcher and researcher as cultural member.

Following such characteristics, data can be collected according to the following procedures.

#### 4.3.4.1 Participant Observation

Participant observation is conducted by directly involving the researcher in the daily life of an organisation. This observation enables the researcher to understand and explore organisational life beyond formal procedures and structures (Bryman 1989). This can be done by observing actors' behaviour and systematically recording events, situations, behaviours and other social settings during the period of observation (Bryman 1989; Marshall and Rossman 1999). Data gathered through this method includes description of programs, behaviours, feelings and knowledge. Such a description can explain what was going on, how it happened and who was present in the situation (Patton 1987). Data can be collected in the form of field notes (which should include the date of the time of data collection and describe where the situation occurs, what the setting is like, how the situation came about, who participated in it, what is said, the researcher's opinion and feelings about the situation).

#### 4.3.4.2 Interview

Interviews play an important role in gathering case study information because they enable the researcher to record opinions, feelings and emotions of participants regarding the studied phenomena (Fetterman 1998; Yin 2003). Thus, data obtained from this source comprise narratives from interviewees about their knowledge, opinions, emotions and experiences.

To help the researcher organise the interview process, a number of interview methods are available, such as a scheduled standardised interview, a non-scheduled standardised interview, and a non-standardised interview (Denzin 1978; Fontana and Frey 1994; Patton 1987). Questions could be designed according to the organisational positions of interviewees by considering their personal knowledge and experience. Interviews could be conducted by using a face-to-face approach. Besides the formal interview, an informal interview could be conducted during the period of field research.

#### 4.3.4.3 Examination of Organisational Records

Organisational records are sources of data gathered directly from the organisation. Documentation plays an important role in qualitative research because such documents can be used as valuable sources for corroborating other evidence collected from the field (Bryman 1989; Marshall and Rossman 1999). Examination of relevant documents enables researchers to analyse why and how financial reporting is practised in an organisation. Documents collected for a case study include administrative records (minutes, information statistics, annual reports), letters, memoranda, agendas, regulations and other legal rules (Marshall and Rossman 1999; Yin 2003).

## 4.4 RESEARCH SETTING

This study will use *Bintang* as a research setting. *Bintang* is a national insurance company listed on the Jakarta Stock Exchange since 1989. The reason for using the company as a research setting is that insurance business in Indonesia is highly regulated—not only by accounting standards, but also other regulations released by the Jakarta Stock Exchange, the Indonesian Capital Market Supervisory Agency (*Bapepam*) and the Ministry of Finance-Republic of Indonesia.

Furthermore, *Bintang* can be seen as successful in implementing a corporate governance mechanism. This can be inferred from *Bintang's* ability to cope with the Indonesian economic crisis that saw other companies go bankrupt. *Bintang* has also been able to show itself as a transparent and accountable company. Annual report awards received by the company since the 1980s are evidence that the company is an example of one who practises good financial reporting practice in Indonesia, especially in the insurance industry. Finally, the reason *Bintang* was chosen as the research setting was that it has a unique culture influenced by the Javanese views on an ethical social relationship.

Gaining access to the company was not an easy task. This is a classical problem faced by accounting researchers in Indonesia. Considerable time elapsed before the researcher was welcome in the company. Initially, an email was sent to the company to ask permission to do the field research. The administration officer responded to the email, "thank you for your attention to the company, I will forward your email to the corporate secretary". However, there was no response for two months.

An email describing the research objective and approach was then sent to a community of Indonesian researchers to ask for help. There were a number of comments in response to the email, both supporting and criticising such a research approach because of difficulties in gaining access to Indonesian companies. Fortunately, one email stated that the President of the Board of Directors of *Bintang* graduated from the university at which the researcher worked.

Another email, with a letter describing the reasons for choosing the company as a research setting attached, and a letter of reference from the researcher's supervisor was sent to the company. The email read: "Please send the attachment to the President of the Board of Directors of *PT. Asuransi Bintang, Tbk*". Twelve hours after sending the email, the President of the Board replied directly: "Mr Chariri, I understand what you wanted to do with your research. I welcome you to my company, and I would ask the Finance Manager to help you collect data. I hope he has enough time to help you to finish your study. By the way, I graduated from Diponegoro University in 1980".

With the imprimatur of letter from the President of the Board, the field research was undertaken in *Bintang* from July to December 2004. Data were gathered through observation, interviews and document analysis for a period of six months. The data were then analysed, as described below, to try to understand the dynamics of financial reporting practice in *Bintang*.

## 4.5 DATA ANALYSIS

### 4.5.1 Methods of Data Collection Applied in this Study

This study mostly used interviews to collect data. However, using a single-data collection approach to understand the dynamics of financial reporting practice in *Bintang* might have resulted in misunderstanding. To improve the credibility of the research findings, this study also employed observation and document analysis. A combination of such methods enabled the researcher to describe and interpret the financial reporting practice of *Bintang*.

First, the company's annual reports and internal company documentation were examined. This step was partly conducted onsite in the office of the Manager of Human Resource Development, which was not occupied. Access to some confidential company documents (such as minutes of meetings of the audit committee and the Board of Commissioners) was allowed, but the corporate secretary supervised, and did not permit photocopying of certain documents. Other sources of documents (such as regulations issued by both the Ministry of

Finance and *Bapepam*, and comments by relevant actors published in national newspapers) were also utilised and analysed to understand the view of external constituents concerning the financial reporting practice of insurance companies.

Both informal unstructured interviews and formal semi-structured interviews were conducted with a variety of organisational members, ranging from top executive officers to those in lower positions. However, only fifteen detailed interviews, using a semi-structured model, were carried out with organisational members who had a good understanding of the financial reporting practice of the company. The organisational members who participated in interviews (excluding the CEOs) were selected by the researcher according to the names available in the list of company's employees.

Interviews were performed individually and lasted between thirty minutes and two hours. Most interviews were recorded on a digital recorder, but in some cases only notes were taken. Interviews were mostly conducted to understand the perception of these individuals concerning organisational culture, leadership style, the mechanism of preparing annual reports, the role of regulations, and a view of how the company and powerful actors respond to external pressures. As suggested by the corporate secretary, interviews were mostly conducted between Tuesday and Friday, because on Monday, employees had a large workload after the weekend and seemed to work under pressure on Friday.

Third, observation was conducted to gain data to support the results of interviews and archival analysis. Observation allowed the researcher to understand and observe things or events that might be missed by other methods.

Because the corporate secretary of the company introduced the researcher and research approach to all organisational members, they were aware that the researcher was observing them.

An example of this observation was an event that occurred on 7 September 2004. The head of the Accounting Division (*Pak* Johny) spoke very loudly to his subordinates: “Where is the entry? Check it again carefully. It is impossible that you did not find it. Look at entries in the 2003 books”. Out of curiosity, the researcher asked an accounting staff member (Mr D) about what was going on. The employee said that there was a mistake in an entry. The prepaid claim account had been recorded in another account. *Pak* Agus was responsible for the entry and was trying to correct the problem. *Pak* Jenry was also helping to search for the source of the mistakes because he felt that such an entry was also his responsibility. The head of the Accounting Division was also investigating the sources of the mistakes. Although he looked upset, he still gave assistance to his subordinates.

They checked the entries one by one on a computer and used supporting documents to find the source of the mistakes. When the researcher asked an accounting staff member (Mr A) about *Pak* Johny’s character, he said: “It is *Pak* Johny’s style, he always speaks like that. However, he never holds on to his anger”. With data gained from interviews and document analysis, this example can be used as to understand and describe an example of the organisational culture, collectivism, leadership style or the exercise of power.

### 4.5.2 Data Analysis: Interpretation and Triangulation

In qualitative research, there is no single approach to analysing data. The choice of methods is largely dependent on research questions (Baxter and Chua 1998); and research strategies and the theoretical framework (Glaser and Strauss 1967). Considering the research questions and the theoretical framework of this study, data were manually analysed using a method suggested by Marshall and Rossman (1999) and Seidel (1998).

To carry out qualitative data analysis, it is necessary to capture, record, interpret and convey information. This is because data and facts do not speak for themselves (Baptiste 2001; Hodgson 1988). For Marshall and Rossman (1999), data analysis consists of processes of ordering and making sense of different types and large quantities of data. Marshall and Rossman (1999) proposed six general phases of data analysis referring to data reduction and interpretation. In line with data reduction, the steps of analysis include organising data, generating categories, themes and patterns, and coding data. On the other hand, interpretation is undertaken through the following steps of analysis: searching for alternative explanations, and writing the report.

Considering such steps of analysis, in qualitative research, data analysis cannot be isolated from data collection. When the initial data were collected from interviews, observation and archival sources, data analysis was immediately conducted to decide on subsequent data collection. This process runs continuously to make results and findings more credible. To quote Seidel (1998, p. 2), qualitative data analysis is an iterative and progressive process involving a harmony of “noticing, collecting and thinking about things or events”. This is why this study employed a triangulation approach involving multi-evidence and theories. In line with Stake (2000), the theoretical framework and evidence gathered from the research setting were utilised to interpret and explain data.

With respect to data reduction (organising data, generating categories/themes and coding the data), detailed interviews were transcribed and arranged in a systematic manner, according to the recommendation of Turner (1981), then translated into English and drafted. This process was also conducted for field notes written during observation. During this stage, the contents of interview transcripts and field notes were organised and coded under the following themes as predetermined by the study objectives and theoretical framework:

a) reasons for publishing annual reports
b) organisational culture
c) institutionalisation
d) a corporate governance mechanism
e) institutional pressures
f) leadership
g) power mobilisation.

It should be noted that a number of details have been changed to preserve anonymities. For the purpose of the quotes provided in data analysis (Chapter Five to Eight), each individual was labelled as A, B, and so on, so that their responses could be distinguished. These processes were then followed by a process of cutting and filing the interview transcripts, and adding observation documents and archival sources according to their contents. Here, the data were analysed by methods of inductive reasoning (Lincoln and Guba 1986) to assess whether the data contributed to answering the research questions.

To enhance the understanding of the researcher of the phenomena being studied, the next step in analysis was to include organisational and sociological theories as alternative explanations to what had occurred in the organisation. By doing so, the patterns identified in data could be matched with the existing theory to ensure their validity (Glaser and Strauss 1967; Yin 2003).

The findings of this study are presented in Chapter Five to Chapter Eight. This study shares an approach with Ferriera and Merchant (1992), that direct quotations, narrations and stories are included in these chapters to illustrate emotions, feelings, views and the interpretation of organisational members of *Bintang* concerning institutional pressures, cultural environment and other social aspects that influence financial reporting practice of the insurance company. By employing such an analysis, this study was able to describe the dynamics of financial reporting practice of *Bintang* (in Chapter Five to Chapter Eight).

### 4.6 CONCLUSION

This chapter described the integrated theoretical framework used to understand the dynamics of financial reporting practice within an institutional, political and cultural context. This study did not set out to test a set of specific hypotheses, but to observe and describe the actions and views of organisational members of *Bintang* and to identify the meanings underlying such actions (Burchell, et al. 1980; Harre and Secord 1972; Nahapiet 1988).

This research was designed as an interpretative study as suggested by Nahapiet (1988), Boland and Pondy (1983) and Burchell, et al. (1980), who claimed that from an interpretative approach, a process by which meanings that people attach to their social worlds are created and sustained are the central focus of understanding social actions. This study employed an ethnographic case study and involved multiple evidence. Data were analysed through a process of data reduction and interpretation (Marshall and Rossman 1999) and through an iterative and progressive process focusing on a harmony of noticing, collecting and thinking (Seidel 1998).

# CHAPTER FIVE
# *PT. ASURANSI BINTANG, TBK*: A BUSINESS INSPIRED BY THE INDEPENDENCE OF INDONESIA

## 5.1 INTRODUCTION

As a socially constructed reality, financial reporting practice can be understood by analysing the relationship among actors in an organisation and between the actors with other external constituents and the environment. This involves the need for understanding the historical background of an organisation, its organisational culture and governance systems, and the involvement of individuals in the construction of financial reporting practice. Consequently, to fully understand financial reporting practice as a socially constructed reality, how financial reporting is practised in a real organisation must be described.

*Bintang*, a publicly listed company, was chosen as a research setting because this company has a unique culture. Furthermore, *Bintang* has been successful in implementing a corporate governance mechanism that drives its organisational members to commit to quality financial reporting practice. This can be inferred from its ability to cope with the Indonesian economic crisis (1997) while other companies went bankrupt, and from its success in winning a number of annual report awards since the 1980s.

This chapter will describe the background of the research setting. The first section will depict the genesis of *Bintang.* This will be followed by a section describing its organisational culture, governance and accountability, and how the company was the recipient of a number of awards. A detailed analysis of financial reporting practice in *Bintang* will be discussed in the next three chapters.

## 5.2 THE GENESIS OF *BINTANG*: A SPIRIT OF INDEPENDENCE

*Bintang* was established as a national-private insurance company by a group of activists in the 1945 Indonesian independence movement, on 17 March 1955, ten year after the independence of Indonesia was proclaimed. The company was established based on Notary Deed No. 63 signed by Raden Meester Soewandi. The founders were Idham, Soedarpo Sastrosatomo, Wibowo, Pang Lay Kim, Ali Algadri, Roestam Moenaf, J.R. Koesman and Ismet.

The founders established *Bintang* for the initial purpose of improving the social life of the Indonesians at a time when economic and trading activities were still dominated by foreign businesses especially those from the Netherlands. One of the founders, who is currently the chairman of the Board of Commissioners, continuously reminds organisational members of the company of the reasons why the founders established *Bintang*. For example, at the 2004 Management Annual Meeting of *Bintang* held on 4 February 2004, he said that:

> …the founders of this company consisted of those who struggled for the independence of Indonesia. They had different backgrounds and skills from military skills to administrative skills. When we gained our independence, the founders faced the challenges of how to make our independence useful. None of us was able to manage this country alone, but we all had a spirit to develop it. Thus, when a Deutch insurance company offered me a partnership, I established a private insurance company in 1955. This is the genesis of *Bintang.* (My translation from a speech by Mr Soedarpo Sastrosatomo, in the Management Annual Meeting of Bintang 4 February 2004.)

Thus, the original purpose of the company was not primarily to earn profit. Rather, it was a means of realising the essence of independence after Indonesia had been colonised by the Netherlands for 350 years and by Japan for 3.5. To maintain the spirit of independence, the founders institutionalised the values of independence for the organisational members of the company. At the same meeting, Mr Soedarpo Sastrosatomo remarked that

> *Bintang* not only raises money, but also makes our independence more useful so that we can fight in our own country. We have a holy spirit. The founders have institutionalised the holy spirit in *Bintang*, to enable its organisational members to utilise our independence and to improve the prosperity of our society. It is your job to maintain the spirit. (My translation from a speech by Mr Soedarpo Sastrosatomo, in the Management Annual Meeting of Bintang, 4 February 2004.)

The "institutionalisation of the spirit of independence" in *Bintang* was also supported by the Director of Financial Services. He said on 24 August 2004:

> …what I know from *Bintang* is that *Bintang* has been directed to conduct clean and ethical business...Even though it is very difficult to do that, and we know our business environment is dirty, I see that there is a spirit in this company to achieve this. This spirit has been institutionalised by the founders. (My translation.)

In addition, the Director of Administration Services, who is also a son of a founder, maintained on 8 September 2004 that

> ...this company has been run with an idealistic vision and mission institutionalised by the founders...The organisational culture of this company is conservative. *Bintang* is more like a government entity rather than a business entity. (My translation.)

The above statements insinuate that it is not simply the spirit of capitalism that drives *Bintang* to conduct an ethical business, but also the spirit of Indonesian independence.

As business activities are competitive, *Bintang* has changed its ownership structure from a private company into a public one. The Initial Public Offering (IPO) of *Bintang* was undertaken on 29 November 1989 by issuing 1,000,000 shares on the Jakarta Stock Exchange and the Surabaya Stock Exchange. The main shareholders of *Bintang* are institutional investors: *PT. Srihana Utama*, *PT. Ngrumat Bondo Utomo* and *PT. Dana Harta Keluarga,* which recently held 30.44 per cent, 19.20 per cent and 7.42 per cent of *Bintang's* shares respectively. The remaining shares (42.94 per cent) are held by individual investors. Since the IPO, *Bintang* has developed as one of the largest general insurance companies in Indonesia. Currently, *Bintang* comprises of eleven branch offices, two representative offices and six sales offices located in three islands: Java, Bali and Sumatra.

*Bintang* has experienced many business challenges because the general condition of the Indonesian economy has fluctuated over time. The hardest period faced by *Bintang* was the period after the financial crisis hit the Indonesian economy in 1997, which led *Bintang* to change its organisational arrangements (the 2001 annual report of *Bintang*). Furthermore, as the company's infrastructures are an important aspect in supporting competition in the insurance market and in maintaining the progress of the company, in 2001 *Bintang* restructured its supporting units (the 2002 annual report of *Bintang*). The personnel unit, for example, has been changed into the Human Resources Development unit. In addition, when the field study was being conducted, an integrated information system, called "The 2010 System", was being developed to support information flow among organisation units and between the head office and branch offices (the 2003 annual report of *Bintang*).

It is recognised that although *Bintang* has been managed differently from time to time, the company has always run under its original philosophy. That philosophy is that the business is built on three integrated interests: shareholders, directors and employees, and customers and societies (the 2001 Annual Report of *Bintang*). The founders continuously remind *Bintang*'s organisational members of this philosophy at any opportunity. The philosophy is also institutionalised by the Board of Directors through the use of a formal rule, *Kesepakatan Kerja Bersama* (Mutual Working Agreement), which is a code of conduct, and other written media (desk calendars, or a statement of the values of the company are found in every room in *Bintang*). The philosophy and core values of running an insurance business have been translated into the organisational culture of *Bintang*. The following section will further illustrate this.

## 5.3 ORGANISATION CULTURE: FROM VISION TO BEHAVIOUR

*Bintang* has always developed its vision and culture in order to accomodate environmental change (the 2002 annual report of *Bintang*). In 1999, for example, *Bintang* redefined its vision for the period up to 2007. In the 2002 annual report (p. 33), the vision of company is stated as

> …to become a leading player and an innovator in the consumer insurance business by employing highly skilled and productive people, for the purposes of achieving business growth and providing benefits to shareholders, the employees and the clients; through the maintenance of the company's values and compliance with governing regulations.

To realise its vision, *Bintang* developed core values that are considered to be the company's organisational culture. Public accountability, conservatism, and transparency are discourses of daily activities and are parts of its organisational culture. The core values of the company consist of the elements of commitment, positive thinking, credibility, acceptance and carrying out of responsibility, prudence in all business decisions, team work, understanding and enjoying business ethics, high customer services and innovation (the 2001, 2002, 2003 annual reports of *Bintang*).

The core values of *Bintang* are based on the daily behaviour of its organisational members. This means that it is *Bintang* itself that builds the organisational culture. The President of the Board of Directors argued on 16 September 2004 that:

> …the core values of *Bintang* are built and translated into practice by people of *Bintang*. Thus the process of building organisational culture is not top-down…The core values are developed from the internal environment. A consultant was asked to design the official form of the values but the contents come from *Bintang*. The middle managers were asked to explore and formulate the values and they called the values "*MAJU"*. (My translation.)

The core values are then finally formulated as a company motto, "MAJU"[29], which is an abbreviation of M A J U, and has these meanings:

> ***M****endukung pencapaian Visi dan Misi perusahaan serta melaksanakan kebijakan yang telah ditetapkan*
> (supporting the achievement of company's vision and mission, and obeying the policies and rules that have been institutionalised in the company)
>
> ***A****manah dalam menjalankan tugas dan tanggung jawab serta senantiasa mencari cara terbaik untuk mencapai tujuan*
> (being professional and trustworthy in carrying out the duties and tasks, and continuously looking for the best and ethical ways of achieving goals)
>
> ***J****ujur, mampu bekerja bersama, saling menghormati, disiplin, dan bersedia melakukan perubahan yang bermanfaat bagi semua pihak*
> (being honest and disciplined, building teamwork, respecting each other, and being able to make a useful change for all stakeholders)
>
> ***U****nggul dalam memberikan pelayanan, memahami kebutuhan pelanggan dan menciptakan produk/jasa yang berkualitas secara berkesinambungan*
> (being outstanding in providing services, understanding customers' needs, and being innovative in creating sustainable, quality products/services)

To implement the core values in daily activities, the company has institutionalised a new performance appraisal system called "*Sismajaprima*"[30]. Within this new appraisal system, all elements of company values are included as parts of an individual performance assessment.

In general, even though it is not easy to implement its organisational culture, *Bintang* has been successful in shaping its organisational members. Indeed, most of the employees agree that they understand the organisational culture of *Bintang* and how to implement it. A view on the organisational culture

[29] In Indonesian language MAJU consists of different meanings. In the context of *Bintang*, MAJU means superior and getting better in conducting business.
[30] *Sismajaprima* explains technical and detailed procedures of assessing employee's competence. However, it is beyond the scope of this study to discuss a technical aspect of such assessment.

of *Bintang* can be seen from a new employee's (Mr C) reason for joining *Bintang*. He maintained on 7 September 2004 that:

> …the organisational culture here is good. We know that all companies have their own cultures, but I see that *Bintang* has an ethical culture. We are committed to conduct an ethical business and all employees feel that they are important parts of *Bintang*. We have a reliable teamwork, which is able to support each other. (My translation.)

The organisational culture of *Bintang* has also shaped the organisational life of *Bintang* like a family. In other words, the management style of *Bintang* is of a family type. The following narratives illustrate that the company has been managed like a big family, which is characterised by tolerance, solidarity, close relationships and open communication.

> It is true that the relationship among employees and between employees and those in the top positions is like family relationship. (My translation from a statement by Mr A, who has worked at *Bintang* for more than 30 years, on 3 September 2004.)
>
> I work here because this company is unique. The relationship among employees and between directors and employees is good, like a family. *Bintang* has a unique culture. Solidarity and tolerance is high in this company...(My translation from a statement by the head of Internal Audit Unit on 9 September 2004.)
>
> The working environment in *Bintang* is good. The relationship among employees is like a family. Such a relationship makes communication easy. (My translation from a statement by Mr B on 9 September 2004.)

A convincing argument in regard to the organisational culture of *Bintang* can be seen from the return of the Director of Financial Services of *Bintang*, who has worked there since 1983. However, in 1992 he resigned and worked in other companies, but in 1996 returned. He said on 24 August 2004:

> Why did I return to *Bintang*? I do not really know. I love *Bintang*! When I worked at two other different companies, I felt that I missed something in *Bintang*. It is difficult to define...The working environment, individual relationship and culture of *Bintang* are very different from those of the two companies. When I worked at *Dharmala*[31], the holding company was very dominant in influencing my decisions. Another company I worked at was *Bimantara*[32], as you know, a company with political power. I could compare the two companies to *Bintang*, which is a single fighter. I saw that it is so different in the way they do business. This motivated me to return to *Bintang* in 1996. (My translation.)

Statements by those who work daily at *Bintang* show that its organisational members understand well what constitutes the culture of *Bintang*. They also believe that the culture is not a negotiable reality. This can be seen from a statement by one of the employees in the Accounting Division who has worked in *Bintang* since 1974. He (Mr A) claimed on 3 September 2003 that

> With respect to the organisational culture, I believe that all employees understand the culture and have implemented the core values. Otherwise, he/she will certainly leave this company. (My translation.)

A manager (Mr G) who is responsible for the Underwriting Division also enunciated a similar view. He affirmed on 15 September 2004 that:

> …good corporate governance has been implemented by management for internal improvement. This can be seen from the current programs implemented to clean from *Bintang* those who neglect our culture. Employees who do not accept our culture cannot continue staying here...(My translation.)

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[31] *Dharmala* group was a holding company owned by the Indonesian Chinese. This group was controlled by the Gondokusumo family. The *Dharmala* group went bankrupt in May 2000 after the banking business associated with the group collapsed.

[32] *Bimantara* is a company owned by Bambang Triatmodjo, a son of Soeharto, the former president of Indonesia. Bambang was previously well known as a businessman who used political power (his father's position) to run his business.

The above statements imply that the organisational culture plays an important role in shaping the behaviour of its organisational members and in driving them to commit to ethical conduct. The success of conducting an ethical business is an organisational reality where the members of the company have been shaped by the organisational culture. Public accountability, transparency, conservatism and ethical business are beliefs taken for granted in *Bintang*.

To build and implement an ethical culture is not easy. *Bintang* has experienced difficulties in implementing ethical conduct because the Indonesian business community has been surrounded by corruption, collusion and nepotism. The organisational members of *Bintang* might be at crossroads: choosing ethical or unethical business. An internal auditor (Mr B) who has worked at *Bintang* for 25 years explained such a condition. He said on 14 September 2004:

> We as internal auditors have worked hard to remind employees in branch offices to conduct a clean, ethical and transparent business. However, it is not easy because our business also deals with government and we know the condition of our government, it is dirty! (My translation.)

Similarly, the Director of Financial services, who worked at different companies, claimed that conducting an ethical business is not easy, especially when the environment does not support such business. He said on 24 August 2004:

> …as *Bintang* is committed to ethical business, we suffer from this problem [unethical business] when we compete with other insurance companies, which enjoy illegal practice. (My translation.)

The above narratives illustrate that to some extent the organisational culture of *Bintang* has been able to guide its organisational members to implement the company vision into daily behaviour. Indeed, *Bintang* has been able to implement ethical business despite the business environment defying it. The ability of *Bintang* to implement an ethical business is also influenced by the manner in which the company views its stakeholders and designs its corporate governance.

## 5.4 ACCOUNTABILITY AND GOVERNANCE STRUCTURE

The corporate governance mechanism of *Bintang* is developed for the purpose of public accountability, and is implemented to obey regulations and socially acceptable values and norms. It is claimed that the reason why *Bintang* was able to cope with the economic crisis in 1997 is the fact that *Bintang* was committed to the implementation of good corporate governance principles (the 2001 Annual Report of *Bintang*, p. 22). Previously, good corporate governance principles adopted by *Bintang* were based on three pillars: transparency, independence, and accountability. However, since 2002, *Bintang* has also adopted corporate governance principles developed by the Organisation for Economic Coordination and Development (OECD). The reason for this is that *Bintang* competes in the insurance market not only with domestic insurance companies, but also with foreign companies (the 2002 annual report of *Bintang*).

Fortunately, in March 2000 the National Committee on Corporate Governance (NCCG) also released the *Code of Good Corporate Governance/Rev.*

*4.0*, which is based on the OECD version. The Jakarta Stock Exchange also supports the implementation of good corporate governance, and the directors of the Jakarta Stock Exchange (JSX) issued letter no. KEP-315/BEJ/06.2000 dated 1 July 2002 stating that good corporate governance is mandatory for publicly listed companies.

### 5.4.1 Stakeholders as a Focus of Accountability

*Bintang* believes that trust is a key success factor in the insurance business. To create and maintain trust, *Bintang* has set a code of business ethics. According to this code, *Bintang* is accountable to all stakeholders[33]. Orientation to stakeholders is mainly influenced by the business philosophy of *Bintang,* which states that the company respects the integrated interests of shareholders, directors and employees, as well as customers and society. This philosophy means that the company considers stakeholders to be an important aspect of running the business. Consequently, *Bintang* takes a wide perspective in formulating codes of business ethics, which consist of elements as follows (the 2001, 2002, 2003 annual reports of *Bintang*):

1. General
   - Always obey all rules and regulations
   - Avoid any conflicts of interests
   - Focus on commitment
   - Provide useful contributions to the environment in which the company operates

2. Shareholders
   - Respect the rights of all shareholders by providing suitable returns in accordance with regulations
   - Provide all shareholders with equal access to information

[33] This statement can be seen on all annual reports of *Bintang.*

3. Employees
   - Work together with labour unions to encourage all employees to obey *Kesepakatan Kerja Bersama* (Mutual Working Agreement) and other relevant rules and regulations
   - Enhance the awareness of employees to the company's core values (MAJU)
   - Provide equal opportunities to all employees regardless of physical appearance, religion, ethnicity and gender.

4. Clients and business partners
   - Respect commitment that is mutually agreed
   - Never offer or accept any valuable gifts/donations that can influence professional policies.

To maintain and implement the code of business ethics, all employees receive copies of *Kesepakatan Kerja Bersama* (Mutual Working Agreement) explaining the rights and obligations of employees. It is claimed that this agreement explains comprehensively the rights and obligations of employees. A statement by the President of the Board of Directors at the 2004 Management Annual Meeting held on 4 February 2004 illustrated such a claim. She said:

> It is not easy to split those with ethical conduct from those with unethical conduct...We also have codified all matters related to the rights and responsibilities of employees in *Kesepakatan Kerja Bersama* (Mutual Working Agreement), as a code of conduct. Indeed, The Office of Labour Force said that there is no working agreement as complete as the agreement set by *Bintang*... (My translation.)

The above statement implies that *Kesepakatan Kerja Bersama* can be seen as a part of the institutionalisation of the company's values to direct all players in *Bintang* to commit to ethical conduct and to focus their attention on public accountability. Powerful actors involved in the corporate governance mechanism of *Bintang* play roles in such institutionalisation.

### 5.4.2 Actors in the Corporate Governance Mechanism

Based on the 1995 *Law on Limited Liability Company* and the *Code of Good Corporate Governance/Rev. 4.0* released by the National Committee on Corporate Governance, *Bintang* adopts a two-tier board system, namely the Board of Commissioners and the Board of Directors. The boards are supported by an Audit Committee, a number of executive committees, internal auditors and a corporate secretary. The following sections will briefly describe the organisational actors of *Bintang*.

#### 5.4.2.1. Board of Commissioners

In *Bintang*, the Board of Commissioners is the actor who is responsible for supervising the Board of Directors. The Board of Commissioners is appointed for a period of three years through an appointment mechanism at the annual general meeting of shareholders. To run its roles, the Board of Commissioners is supported by an Audit Committee and remuneration committee.

The Board of Commissioners consists of five actors: a chairman and four commissioners. The chairman of the Board of Commissioners is the founder of *Bintang,* and two of the board members are independent. This Board consists of unique members with different backgrounds. When this field research was undertaken, the members of the Board were the founder, professionals and an academic, who is also a senior managing partner of an audit firm. Understanding their qualification, experience and background provides a picture of how they shape the organisational reality of *Bintang*[34].

The chairman of the Board of Commissioners is Mr Soedarpo Sastrosatomo, the founder of *Bintang*. He has been awarded the three stars of merit from the Government of Indonesia and one merit from the Kingdom of Netherlands. In the era of the Indonesian independence movement, Mr Sastrosatomo was appointed as an employee of Foreign Affairs, a division within the Ministry of Information (1945–1948). He was then appointed as a member of an Indonesian delegation to the Security Council of the United Nations in New York (1948–1950)[35] and a consul of the Indonesian Embassy in Washington D C (1950–1952). When he retuned to Indonesia in 1952, he established a number of companies including *Bintang* (1955). He has acted as a commissioner of *Bintang* since 1979. Currently, besides acting as the Chairman of the Board of Commissioner of *Bintang*, he is a commissioner of a number of companies.

As someone directly involved in the independence of Indonesia, Mr Sastrosatomo has shaped the organisational reality of *Bintang* by institutionalising the "spirit of independence". Individuals in *Bintang* claim that Mr Sastrosatomo not only has personal charisma, but also has a cultural influence over *Bintang*. The

[34] The researcher believed that commissioners' profiles was important because they have greatly influenced the company's image, and are seen by organisational members of *Bintang* as charismatic leaders

[35] During this period the Netherlands came back to Indonesia and occupied Indonesia; this problem was resolved by the United Nations.

Board of Directors recognised the important role of Mr Sastrosatomo in *Bintang* and said:

> With an astute business instinct and clear forward looking, he (*Mr Sastrosatomo*) has directed the Board of Directors to the future of *Bintang* (the 2003 Annual Report of *Bintang*, p.21).
>
> Sometimes, when an agreement has not yet been reached among the members of the Board of Commissioners, he will take an initiative to make a decision by considering a number of aspects carefully (the 2002 Annual Report of *Bintang,* p.24).

The second commissioner is Mr Munir Samsoeddin. He was previously a general manager of *Bintang* (1979–1982) and the President of the Board of Directors of *Bintang* (1982–1989). He has acted as a commissioner of *Bintang* since 1995 and as a commissioner and the president of the board of directors in other companies. Mr Samsoeddin was also the Chairman of the Indonesian Insurance Council (1996–2002) and Chairman of the Asian Insurance Council (2000 – 2001). People in *Bintang* maintain that Mr Samsoedin has contributed significantly to the development of *Bintang*. For example, the Board of Directors sees Mr Samsoeddin as

> …a figure that influenced the insurance business in Indonesia. He played an important role in evaluating and reviewing performance and policies made by the Board of Directors, especially policies related to marketing and technical aspects of the insurance business (the 2003 Annual Report of *Bintang*, p.22).

The third commissioner is Mr Amir Abadi Jusuf. He is an active managing partner of an audit firm and a lecturer at the University of Indonesia. Mr Jusuf is also active in the development of accounting in Indonesia through his involvement in the Indonesian Institute of Accountants (IAI). He was the chairman of the

Professional Standard Committee of IAI (1994–1998) and the chairman of Public Accounting Compartment of IAI (1997–1999). Since 1998, he has been a member of the Consultative Board of the Financial Accounting Standards Committee of IAI and a member of the Professional Judicial Board of IAI. Besides his involvement in professional activities, Mr Jusuf also acted as an independent commissioner and Audit Committee member of two other companies. The Board of Directors perceived the important role of Mr Jusuf as follows:

> With his undoubted expertise in accounting and finance and his detailed analysis of accounting figures, he [Amir Abadi Yusuf] has a task of evaluating and reviewing the company's financial performance and policies (the 2003 Annual Report of *Bintang*, p.23)

The fourth commissioner is Mrs. Indraningsih Wibowo. She is a widow of a founder of *Bintang*. Even though she is indirectly related to *Bintang*, the Board of Directors claims that she is an independent commissioner. She is also a commissioner of other companies. The Board of Directors expressed its appreciation to Mrs. Wibowo as follows:

> Her [Indraningsih Wibowo] involvement in the Board of Commissioners is valuable for *Bintang*. Her experience as a commissioner in a number of other companies supports the supervisory functions of the Board of Commissioners... (the 2003 Annual Report of *Bintang*, p.24)

The last commissioner is Mr Abdullah Fawzy Siddik. He has acted as an independent commissioner of *Bintang* since 10 June 2003, replacing Mr Andy Roestam Moenaf, who was appointed as the Director of Administration Services of *Bintang*. Mr Siddik also acts as the chairman of the Audit Committee. Besides playing a role in *Bintang*, he has acted as the president of the board of directors in a number of companies and was the chairman of the board of commissioners in other companies. Mr Siddik was also a senior auditor in Price Waterhouse (Canada) and has been involved in a number of professional organisations. The involvement of Mr Siddik in *Bintang* has contributed to a major improvement in *Bintang,* especially in regard to the implementation of good corporate governance principles and quality financial reporting. He has also changed the philosophy of the Audit Committee in the current business environment (this will be discussed in Section 5.4.2.3).

The description of actors involved in the Board of Commissioners shows that *Bintang* has unique commissioners. The Board of Commissioners is characterised by people with different backgrounds and skills from professionals, academicians to founders. Although for other companies this diverse background might lead to problems, such a difference has escorted *Bintang* to better control. This is because the values adopted by *Bintang*, such as public accountability, conservatism, and ethical business, are consistent with the values that are widely accepted in professional organisations and education. Thus, there is congruence between the company's values and the values brought by the commissioners whose backgrounds are different.

#### 5.4.2.2. Board of Directors

The Board of Directors is responsible for managing daily business activities by conducting prudent business and implementing good corporate governance principles. The Board is appointed for a period of five years, and since 10 June 2003, it has consisted of one president and three members managing financial, operational and administration services. Currently, *Bintang* is led by a woman as President of the Board of Directors, who started her career as a sales representative in *Bintang* in 1978. This is the first time the company has been led by a woman. Even though a gender bias issue is not crucial in *Bintang*, its organisational members have different perceptions of women. One accounting staff member (Mr A) said on 3 September 2004:

> …a woman as a leader is not a problem for me. But according to my friend (I do not know whether it is true or not) generally for women emotions outweigh rationality in making decisions. (My translation.)

Another director also argued that a gender bias issue is not a problem in leadership. Indeed, he recognised that a woman, as a leader, has been successful in managing *Bintang*. He said:

> …as far as leadership is concerned, *Bintang* has been successfully led by a woman. What I mean here is that a woman, in general, is more concerned with rules than a man. She has been able to show her ethical conduct and worked very hard... sometimes until late night. As a man I am motivated by such behaviour. However, as a woman she is influenced by her motherhood that encourages her to make rules...similar to household rules. (My translation.)

This leadership, including making detailed rules and considering many alternatives, is also recognised by the President of the Board of Directors. She remarked on 16 September 2004 that:

> …considering my position, a woman as President of the Board of Directors, I felt something strange. This might be my personal view. In light of femininity and motherhood, because I am a mother, sometimes when I want to solve a problem, the judgment I make is more complicated than a man. I have to consider so many things in detail. I have to check and recheck everything and have to show some tolerance. I do not know whether because of this style sometimes some people underestimate me...(My translation.)

In performing its jobs, the Board of Directors is supported by the executive committees. It is claimed that the establishment of executive committees was influenced by the government regulations. The Director of Administration Services claimed on 8 September 2004 that

> …the reason for the establishment of executive committees is a trigger from the government, which asks financial institutions to be more accountable and controllable...We establish and utilise the committees for the purpose of showing all actors that we make a collective decision. Directors do not individually make the decisions. We try to develop collectivism. (My translation.)

By using executive committees, the President, directors and other board members build an image that they are not "dictators" who determine everything in *Bintang*. Because important decisions are made by collective efforts, this force actors in *Bintang* to be responsible for conducting business. The Board of Directors is currently supported by the following executive committees:

- *Komite Investasi* (The Investment Committee), which is responsible for deciding investment policies
- *Komite Pengadaan Barang dan Jasa* (The Goods and Services Procurement Committee), which helps the Board of Directors in evaluating and determining the procurement of goods and services whose values are above Rp 50,000,000
- *Komite Evaluasi Penilaian Kompetensi Karyawan* (The Committee on Employees' Competence Assessment), which is responsible for assessing performance of employees for the purposes of promotion, rotation and demotion

- *Komite Reasuransi* (Reinsurance Committee), which is established to evaluate reinsurance programs of the previous period and deciding the reinsurance program for the subsequent period.

### 5.4.2.3. Audit Committee

The Audit Committee of *Bintang* was established on 27 April 2001 to assist the Board of Commissioners in carrying out its supervisory roles. The Audit Committee is responsible for reviewing and providing recommendations on an internal control system and financial reporting practice, company compliance with regulations and laws, an internal audit function and the appointment of external auditors. The Chairman of the Audit Committee is the independent commissioner and is supported by two independent members who have no interests or affiliations with *Bintang*. The Audit Committee of *Bintang* has been actively involved in reviewing the company's policies and ensuring quality financial reporting practice. In regard to the role of the Audit Committee in *Bintang*, the President of the Board of Directors believed on 16 September 2004 that:

> …the Audit Committee plays an important role in this company. We have an Audit Committee charter and internal auditor charter...we currently have regular meetings [with the audit committee]. (My translation.)

The Audit Committee has performed its roles more effectively since the involvement of Mr Siddik. When Mr Siddik was appointed as the Chairman of the Audit Committee, he changed the philosophy of the Board of Commissioners and the Audit Committee. In the Audit Committee Meeting held on 24 June 2004, he argued that the philosophy of the Board of Commissioners should be based on the concept that "business should be manageable through processes rather than functions" (minutes of the Meeting of the Audit Committee, KA 06/04-24 June 2004).

Accordingly, he suggested that *Bintang* should establish other committees, such as a risk management committee and a nomination committee to complement the existing committees. In the meeting, Mr Siddik also explained that the Board of Commissioners plays a role in the process of supervising policies and actions made by the directors in the best interest of the company and shareholders, performing social responsibility and considering the interest of various stakeholders. The Board of Commissioners also legally shares responsibility by signing annual reports along with the directors.

In line with the role of the Audit Committee, Mr Siddik contended that to run its roles effectively, the Audit Committee must be independent and consist of independent commissioners, independent outsiders and key internal audit staff. He also maintained that the Audit Committee must report its activities directly to the Board of Commissioners and that the appointment and replacement of Audit Committee members must be undertaken by the Board of Commissioners.

#### 5.4.2.4. Internal Auditors

The Internal Audit Unit is a crucial part of *Bintang,* especially for purposes of monitoring the implementation of company policies. The function of internal audit in *Bintang* is to provide company management with constructive and protective services in terms of an analytical review, recommendation and useful information regarding company activities. In performing its functions, internal auditors must maintain independence and objectivity and avoid conflicts of interests. By so doing, the mission of the Internal Audit Unit of *Bintang* is to accommodate the interests of shareholders and management and support the implementation of good corporate governance.

Currently the position of the Internal Audit Unit in organisational structure is under the President of the Board of Directors. This means that an internal auditor is responsible to the President of the Board of Directors. However, to maintain independence and objectivity, internal auditors have the ability to communicate any findings to the Audit Committee. The head of the Internal Audit Unit believed that he maintains independence in performing his job. He said on 9 September 2004 that:

> …even though I am responsible to the President of the Board of Directors, I have direct access to the Audit Committee....I am not afraid to criticise any divisions...(My translation.)

In *Bintang*, the Internal Audit Unit consists of four people with educational backgrounds in accounting and insurance, and those who hold a certificate of qualified internal auditing. Internal auditors perform activities such as regular audit, temporary audit (prior to the replacement of the head of branch office) and special audit (in branch offices), and also provide recommendations to the directors.

#### 5.4.2.5. Corporate Secretary

A corporate secretary is another actor who plays an important role in implementing good corporate governance prnciples. In *Bintang*, the functions of the corporate secretary are as follows:

1. To monitor issues concerning capital market activities, especially those that relate to new regulations and law.
2. To deliver services to the public regarding any information of *Bintang*'s activities that the public need to know.
3. To provide information to the Directors of *Bintang* for the purpose of assessing company compliance to any rules, regulations and laws.
4. To serve as a contact person dealing with *Bapepam*, the Directorate General of Financial Institutions and the public.
5. To arrange a general meeting of shareholders and public releases.

The role corporate secretary of *Bintang* is supported by two main task forces: the Legal Unit and the Public Relations Unit. The Legal Unit plays a role as a compliance officer and provides legal services and opinions to the directors, managers, and heads of branch offices. On the other hand, the Public Relations Unit is intended to provide general information to the public, such as media release, and to perform social activities for building and developing a corporate image.

The above description of organisational actors shows that the organisational actors of *Bintang* play important roles in the implementation of corporate governance principles and financial reporting practice. Quality financial reporting is determined by the interaction among actors involved in the corporate governance mechanism of *Bintang*.

## 5.5 FINANCIAL REPORTING PRACTICE

This study is built on the belief that financial reporting practice is an institutional and political practice concerning the supply of information. Based on this ontological point of view, the first question of this study is directed to understand why and how a company is committed to quality financial reporting practice. The following section describes the financial reporting practice of *Bintang* and the reason why *Bintang* is committed to quality financial reporting practice.

### 5.5.1 Organisational Structure of the Accounting Division

As a medium-sized company that deals with service activities in the insurance industry, *Bintang* has practised a relatively simple financial reporting process. Most financial reporting procedures are based on regulations issued by both *Bapepam* and the Ministry of Finance. In the organisational structure, activities concerning financial reporting practice are centralised under the Division of Accounting and Standard Operating Procedures (SOP) Development, which is under the supervision of the Directorate of Financial Services. The division is responsible for reporting information for external and internal purposes. For external purposes, the division is responsible for designing and developing operating procedures and systems, accounting policies, financial reporting systems and taxation reporting systems. For internal purposes, the

Division of Accounting and SOP Development plays a role in planning and controlling the budget, and is responsible for human resource administration and the general administration of this division.

In 2003, *Bintang* changed the name of its accounting division. This is because the name used was seen as problematic by the head of the Accounting and SOP Development Division, who disagreed with the use of "SOP Development" following the word "Accounting" in the Division name. A quotation by the Director of Financial Services on 24 August 2004 illustrates why the name was seen as a problem.

> We also changed the name of the accounting division from *the Division of Accounting and SOP Development* to *the Division of Accounting*. This was a funny change... I have a unique head of division. This man is very dedicated to *Bintang* and worked very hard. Previously, we used *the Division of Accounting and SOP Development* as a name of the division, which was responsible for developing standard operating procedures and any activities related to accounting...He said to me: "I only want to be a head of Accounting, not SOP Development Division. I am too old to be a head of the Accounting *and* SOP Development Division". I tried to convince him that SOP would be under my responsibility and he only worked as a head of accounting. But he still said "NO!" if the name of the division was the same. Finally, to accommodate his request, we decided to change the name from "the Division of Accounting and SOP Development" into "the Accounting Division". (My translation.)

The newly named Accounting Division is led by a head (*Bintang* refers to this as a general manager position) who supervises two actors: an assistant manager of the Accounting Unit and an assistant manager of the SOP Development Unit. The assistant manager of the Accounting Unit supervises two Sub-Managers: a Sub-Manager of Accounting for the Head Office and a Sub-Manager of Accounting for Branch Offices.

A Sub-Manager of Accounting for the Head Office supervises two coordinators: a coordinator of accounting for the head office and a coordinator of Reinsurance Administration. This structural description shows that a number of actors are involved in the financial reporting practice of *Bintang*. However, a detailed job description will not be given here as it is not considered as relevant to the study.

In discussing the dynamics of financial reporting practice in *Bintang,* it is important to note that the company has employed three integrated filters to ensure the reliability of its financial reporting. The first is that any transactions or events in branch offices are always verified and reconciled by personnel in the head office, who are responsible for the accounting of branch offices. The second is the active involvement of internal auditors in reviewing the company's policies and accounting practices in branch offices. Internal auditors have a regular schedule to audit financial reports and for the implementation of the company's policies in branch offices. The last filter is the use of a professional external auditor with an ethical reputation who audits the financial reports of the company.

Most personnel in *Bintang* believe that organisational culture plays an important role in shaping quality financial reporting practice. For example, even though the President of the Board of Directors and Director of Financial Services do not directly say that there is a relationship between culture and quality financial reports, they claim that only those who understand *Bintang* are able to assess such a relationship.

The President of the Board of Directors said on 16 September 2004 that

> I do not really know whether the financial report is a reflection of organisational culture. For example, we could see that some insurance companies provided a high figure in revenues. But we did not know how the company got the revenues. *Bintang* always implements business ethics. But do other companies consider ethical aspects in their business? I do not think so, because we can see how business in Indonesia is... a legal activity is okay, illegal ones are up to you. We are committed to ethical business. Only the "market players" and those who are concerned with *Bintang* are able to assess whether our financial report is a reflection of our organisational culture. (My translation.)

A similar view was held by the Director of Financial Services, who stated on 24 August 2004 that:

> …Financial reports also reflect our culture, although it is not easy for users to directly understand the relationship between organisational culture and the reports. (My translation.)

A convincing argument of the existence such a relationship can be seen from a statement by new employee (Mr C), who previously worked at a famous audit firm in Indonesia (Deloitte). He insisted on 7 September 2004 that:

> ...*Bintang* got an annual report award. I think that it was reasonable. We have an ethical culture and our culture greatly influences the quality of our financial reports. (My translation.)

*Bintang* has a unique culture that influences employees not only in the Division of Accounting, but also in other divisions to behave ethically when carring out their jobs. A statement by one of the accounting staff explained how such a culture shapes behaviour of individuals. He (Mr A) pointed out on 3 September 2004 that:

> I think numbers or data contained in financial statements reflect the moral values or a culture of our company, especially in the Accounting Division. I did not really know what was going on in other divisions. But, I believe they [other divisions] have implemented the same values. (My translation.)

This ethical culture has been institutionalised by both the founders and the Board of Directors, who continuously remind individuals in *Bintang* of the importance of being conservative in conducting business (Chapter Seven will discuss this further). Another employee in the Accounting Division (Mr D) remarked on 23 September 2004 that:

> I believe that the reason why we got annual report awards was that we had honest leaders. They never manipulate accounting data. That is our culture...conservative. (My translation.)

This statement is consistent with a view expressed by the Director of Administration Services, who is also a minority shareholder and a son of a founder. He said on 8 September 2004 that:

> The quality of financial reports is mainly determined by ethical conduct of those who prepare the reports. If you are used to running a business ethically, you will automatically provide the correct information about the company's activities. (My translation.)

Similarly, Mr E, who is responsible for preparing the financial reports stated on 21 September 2004 that:

> There is no a surprise in the annual report awards. With or without the annual report awards we are always committed to quality financial reporting practice. Our financial reports are just like that. (My translation.)

The Financial reporting practice of *Bintang* shows that quality financial reporting is determined by an ethical culture. For *Bintang,* it is not economic factors that drive quality financial reporting; rather it is a reality that is socially constructed by actors in the organisation. The reason for *Bintang*'s commitment to quality financial reporting is its culture (Chapter Seven will elaborate this claim).

### 5.5.2 Why Produce Quality Financial Reporting?

What is a quality financial report and what is it for? There is no single answer to this question. Different points of view will result in different answers. In Indonesia it is not easy to assess what constitutes quality financial reports. However, in the context of the Indonesian environment, the quality of financial reports might be assessed using criteria set by the Committee of the annual report award competition. The competition is conducted by a legitimate institution that is responsible for supporting the implementation of corporate governance principles and for creating an ethical and transparent business practice in Indonesian.

The annual report award is a competition to recognise good corporate governance implementation in Indonesia. The award can be seen as another form of the Financial Report Competition held in the 1970s. The need for the implementation of good corporate governance as a consequence of the 1990s economic crisis is a reason for holding an annual report award. Thus, it is intended to improve the quality of transparency of business practice in Indonesia. Without transparency, the regulatory framework will never be able to increase investor's trust in the capital market[36]. Since 2002, this competition has been hosted jointly by the Ministry of State-Owned Companies, Directorate General of Taxation, Capital Market Supervisory Agency (*Bapepam*), the Jakarta Stock Exchange, the Indonesian Institute of Accountants and the National Committee on Corporate Governance.

In 1980 *Bintang* was the winner of the annual report competition for the insurance industry, and won the same award in 1982. *Bintang* was also awarded as first runner-up of the competition for insurance companies in 1981, 1983 and 1987. In 1986 and 1988, *Bintang* was in third ranked in the competition. In the 2002 Annual Report Award, *Bintang* was awarded as a company with the best annual report. In 2003 *Bintang* gained the fourth position in the 2003 Annual Report Award Competition. Besides awards in financial reporting practice, in 2002 *Bintang* was also the recipient of the Insurance Award.

In regard to quality financial reporting practice, it is interesting to note how employees in *Bintang* view financial reporting practice. They believe that *Bintang* is always committed to quality financial reporting practice and has published true and fair financial reports to the public. The Director of Administration Services maintained on 8 September 2004 that:

> …a good financial report is a report that shows accurate information and provides enough narrative explanation of the company's activities. However, it must tell the truth. *Bintang* has done it. (My translation.)

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[36] See ADB (2003) for a detailed analysis of problems with transparency, accounting and auditing in Indonesia. Even though discussions in this publication mostly refer to the banking industry, it is considered a useful reference and an example that Indonesia has problems with transparency in financial reporting practice.

The quality of financial reports of *Bintang* might be objectively assessed based on comments by outside parties. One of the sub-managers in the Accounting Division (Mr E) explained how his friend was surprised at the quality of financial reports of *Bintang*. Mr E explained on 21 September 2004 that:

> With the implementation of good corporate governance principles, information that the users need was available in the reports. We have provided information they need. And now other companies have copied the way *Bintang* publishes financial statements. When my friend read our financial reports, he said: "Excellent, this report was very comprehensive and transparent". (My translation.)

A former external auditor (Mr C), who is currently employed by *Bintang,* has also a similar view in regard to the quality of the financial reports of *Bintang*:

> If we compare the financial reports of *Bintang* to those of other insurance companies, *Bintang* is the best. I mean, *Bintang* presents transparent and informative figures in the financial reports. When we read the reports we understand what the figures or information mean. (My translation.)

*Bintang* claims that quality financial reporting is a part of its culture. Being transparent, honest and ethical in business, including in publishing financial reports, are part of the company's values. Even though gaining awards is not the main purpose of publishing quality financial reports, such awards are viewed as important media to legitimate the existence of the company. A statement by an assistant manager in the Accounting Division (Mr A) on 3 September 2004 illustrated such a view:

> ...the annual report awards are useful for this company, for example, to enhance the company image. (My translation.).

In addition, the Director of Administration Services argued on 8 September 2004 that:

> ...externally, the award can be used as marketing media, because the insurance business is a business of trust. The annual report awards tell society that *Bintang* is credible and can be trusted. (My translation.)

Furthermore, the importance of a quality financial report in gaining legitimacy is also supported by the head of the Internal Audit Unit, who previously worked at an institution related to the banking industry. He pointed out on 9 September 2004 that:

> ...how *Bintang* is transparently able to report its performance is the accountability of *Bintang* to the public. So it is very important to create an image that *Bintang* does not betray the public in regard to information being published...*(*My translation.*)*.

The above statements support an argument that a quality financial report is intended to gain legitimacy. The company wants to tell the society that, through information contained in the report, the company operates in a socially acceptable way (Chapter Six will discuss this).

## 5.6 CONCLUSION

*Bintang* was established as an insurance company based on the "spirit of Indonesian independence". Because the founders of *Bintang* are substantially made up of those who struggled for independence, the organisational culture of *Bintang* is significantly determined by values perceived by the founders to reflect the spirit of independence. Being conservative, honest, accountable, transparent and ethical in doing business are considered as the company's culture.

The organisational culture of *Bintang* influences its financial reporting practice and consequently, in preparing and publishing a financial report, the values always drive the staff in the Accounting Division to commit to quality financial reporting. The reason for publishing quality financial reports is also seen as being able confer legitimacy on the company. Such publications are intended to maintain social harmony, and form a part of the Javanese ideas of what constitutes an ethical social relationship. The next chapter will discuss how a financial reporting practice is constructed as a rhetorical story to maintain social harmony.

# CHAPTER SIX
# THE POWER OF THE TALE: FINANCIAL REPORTING AS A RHETORICAL STORY FOR SOCIAL HARMONY

## 6.1 INTRODUCTION

This study claims that financial reporting practice is a political and institutional practice involving external forces and the behaviour of actors. Financial reporting is a socially constructed reality that can shape, and be shaped by, both powerful actors and institutional environments. It is also argued that publishing a quality annual report is not without a purpose. Conforming to culture and gaining legitimacy are interesting reasons for publishing quality annual reports. In the case of *Bintang*, it can be seen that financial reporting practice is a dynamic practice involving culture, institutions and power. Financial reporting is seen as a medium for gaining legitimacy, and is consequently designed as a rhetorical story for maintaining social harmony.

The first section of this chapter will address the terminologies used in financial reporting to help understand relevant ideas discussed in this study. The second section will discuss the reason why *Bintang* is committed to quality financial reporting practice. The following sections will analyse why financial reporting is seen as a rhetorical story. These sections will also discuss the nature of rhetoric, and how financial reporting is used by *Bintang* to persuade its audience that the company operates in accordance with socially imposed beliefs, norms and values. Finally, a conclusion will be drawn to consolidate the important points concerning quality financial reporting practice in *Bintang.*

## 6.2 CORPORATE FINANCIAL REPORTING: FOCUSING ON A PERSPECTIVE

When researching issues in corporate financial reporting one might find confusing terminologies used in accounting literature. In relation to financial reporting, there are a number of terms used, such as corporate financial reporting, annual reports and financial statements. Conceptually, as discussed in Chapter Two, corporate financial reporting comprises primarily of audited financial statements prepared in accordance with generally accepted accounting principles. Within this context, financial statements refer to balance sheets, income statements, statements of cash flows, statements of changes in shareholders' equity and notes to complement the financial statements.

However, it should be noted that the scope of financial reporting not only covers the audited financial statements, but also other means of financial reporting related directly or indirectly to information provided by the accounting systems of an entity. This is because accountability requires broadening the scope of disclosure beyond a financial focus to ensure that sufficient and meaningful qualitative information is also included in the corporate financial reports. According to Wolk et al. (2001, p. 302) words, financial reporting is used as "an umbrella term to cover both financial statements themselves and the additional types of information". Thus, financial reporting contains basic information about a company expressed in both financial and narrative terms.

Narrative texts are employed in annual reports to supplement financial information. These include management discussion and analysis (MD&A), and the executive's letters to shareholders (David 2002). The MD&A is used as a medium to interpret and discuss a company's performance. The executive's letter is written as a signed personal letter from the president of the board of directors or chief executive officers. This letter usually provides an overview of past performance and a discussion of plans for the future (Yuthas, et al. 2002).

In practice, however, corporate financial reporting that is annually published is often labelled as an "annual reports". In the case of *Bintang*, "annual financial reporting" (in Indonesian, *"Laporan Keuangan Tahunan"*) is translated in English into "Annual Report". Considering what has generally been accepted in the Indonesian business environment, in this study, the terminology of financial statements refers to statutory statements such as balance sheets, income statements, statements of cash flows, statements of changes in shareholders' equity and notes to complement the financial statements.

On the other hand, the terminology of "corporate financial reporting" or "financial reporting" is used interchangeably with "corporate annual report" or just "annual report", which covers quantitative information (financial statements), narrative texts, photographs, tables and graphs. Corporate annual reports are commonly divided into two sections. The larger first section contains voluntary disclosure in terms of narrative texts, graphs, pictures and tables. The second section, usually allocated to either the rear or a separate volume, comprises statutory required financial statements. Regardless of how such sections are presented, corporate annual reports are published for certain purposes, which are discussed below.

## 6.3 FINANCIAL REPORTING AND SOCIAL HARMONY

A company has legitimacy as a reason for publishing corporate annual reports. However, organisational legitimacy does not occur through merely making a profit and complying with legal requirements. Instead, reference to the existing norms, beliefs and values of society is crucial in ensuring that an organisation has achieved legitimacy. As a device to deliver messages of organisational reality, financial reporting is consequently used to earn legitimacy for maintaining social harmony in the society in which company activities take place.

### 6.3.1 In Search of Legitimacy

It was discussed in Chapter Four that there might be a number of reasons why a company exists and survives in a rapidly changing business environment. Obtaining legitimacy is important for a company because it demonstrates social worthiness and mobilises resources (Oliver 1991). As an organisation consumes resources that have alternative uses, society tends to evaluate the usefulness and legitimacy of the organisation's activities (Parsons 1956). Hence, in the context of organisational interaction with society, Deegan (2001, p. 253) claims that:

> …organisations continually seek to ensure that they operate within the bounds and norms of their respective societies, that is, they attempt to ensure that their activities are perceived by outside parties as being legitimate.

Carruthers (1995, p. 324) also contends that "organisations are not only granted legitimacy; sometimes they go out and get it". In so doing, the organisation can employ certain means or strategies. Ashforth and Gibbs (1990), as discussed in Chapter Four, suggested that there are two general means by which organisations seek legitimacy: substantive management and symbolic management.

Based on strategies offered by Ashforth and Gibbs (1990), a company might create an image that is perceived to be in accordance with socially imposed values. Thus, the company actively seeks images that have positive values, and avoids negatively valued images (Gardner and Martinko 1988). In doing so, "impression management" might be employed in creating annual reports[37]. Different impression management strategies can be adopted for different stakeholders (Marcus and Goodman 1991). It is easier for a company to adopt such strategies because there is power asymmetry affecting how much attention different stakeholders receive (Allen and Caillouet 1994). Consequently, actions made visible by powerful stakeholders will be reframed by accounts in annual reports; actions made visible by less powerful stakeholders will be ignored (Neu, et al. 1998).

In relation to how management seeks legitimacy, it can be argued that *Bintang* has been able to show that substantive management is more important than symbolic management as a strategy in gaining legitimacy. The annual report awards and other awards indicated how *Bintang* has used corporate annual reports

[37] Impression management is a social concept, which is defined as "the conscious or unconscious attempt to control images that are real or imagined in social interaction" (Schlenker 1980, p. 6).

as a medium to gain legitimacy and to increase public confidence in *Bintang*. Gaining public confidence plays significant roles in increasing the public image on which *Bintang* runs socially acceptable activities. This is consistent with a statement by an employee (Mr F) of *Bintang* on 21 September 2004 who said:

> …an annual report award is important for *Bintang* because the award can increase public confidence. This is related to the implementation of good corporate governance principles. (My translation.)

Similarly, one of the branch office heads on 5 October 2004 claimed that:

> …an annual report award is very important for us. When people raise questions about *Bintang*, the award is the answer. The award tells them that *Bintang* has conducted ethical and transparent business. (My translation.)

A statement by an assistant manager in the Accounting Division (Mr A) on 3 September 2004 also supported such a claim. He noted that:

> ... the annual report award is useful for this company for example to enhance the company image. Thus, the society might say, "look, *Bintang* is transparent in providing information of its activities to the public". (My translation.)

In line with the reason why *Bintang* chooses a substantive strategy, it might be useful to consider self-presentation theory. According to self-presentation theory, as Aerts (1994) notes, people (including management) give an explanation for their behaviour that is designed (consciously or not) to defend their claims to positive social identities or images. How people determine coping strategies in their justification is influenced by the nature of what has to be explained and the conditions in which the causal claim are created (Tetlock

1985a). Thus, through these behaviours, individuals (including company management) seek to be perceived as successful, competent, trusted, responsible and rational. In the case of *Bintang*, the Director of Administration Services on 8 September 2004 argued that:

> …an annual report award instils pride in us. Internally by winning the annual report award, the directors can use the award as a medium to institutionalise the spirit of fairness and honesty. Externally, the award can be used as marketing media, because the insurance business is a business of trust. The annual report award tells society that *Bintang* is credible and can be trusted . (My translation.)

The statement shows that trust is an essential part of the search for legitimacy. According to Shockley-Zalabak*,* et al*.* (2003, p. 4) trust is defined as a company's "willingness, based upon its *culture and communication behaviours* in relationship and transactions, to be appropriately vulnerable [emphasis added]". They (2003) concluded that trust is a result of communication behaviour, such as delivering accurate and reliable information of company activities, exposing sincere and appropriate openness and giving justification for any decisions. The manner in which a company delivers messages in a corporate annual report is an important point in a corporate communication strategy, whereby trust can be constructed by convincing others that the company is pursuing a socially acceptable strategy (Kohut and Segars 1992).

One such strategy that enables a company to seek legitimacy is by including narrative texts in annual reports. The use of narrative texts enables a company to tell the reality of an organisation to a society. Aerts (1994, p. 338) argues that:

> narrative accounting reports are one of the means by which corporate management can legitimise the company's activities and outcomes. Verbal behaviour and more specifically, the way in which facts, events and actions are explained, is important, certainly in external relations, because it defines the essential elements of the corporate performance environment and portrays the normative and empirical bases on which to judge the appropriateness of the company actions.

In this regard, what *Bintang* has conducted is consistent with this view. Indeed, narrative texts have been used by *Bintang* to make a true portrait of its historical performance, show insights of its future, and define management capability for the purpose of legitimating its activities. On average, *Bintang* takes up 50 pages of every annual report to write narrative texts on the report.

How and why a company publishes a corporate annual report is influenced by socially acceptable values. Values tend to alter, so a company needs to be reactive to changing values for the purpose of signalling that the company's values are in congruence with socially accepted values (Dowling and Pfeffer 1975). If the company management perceives that their legitimacy is under attack by public concerns, management will react to this by improving the quality of financial reporting, for example, by increasing the level of company disclosure (Brown and Deegan 1998). Consequently, narrative texts are increasingly used in annual reports to support a view that an organisation actively seeks legitimacy.

Another means of increasing legitimacy is by using other communication media such as websites or press releases. These media are employed to deliver certain information concerning public interests that has not been included in corporate financial reporting. The purpose is to "communicate a congruency of actions and values with those of stakeholders seen as important to the legitimation process" (Stanton and Stanton 2002, p. 491).

Even though *Bintang* has been awarded a number of annual report awards, it has experienced a decrease in legitimacy. This is because the rank of annual reports of *Bintang* has decreased from year to year. As an annual report award has been seen as a legitimate indicator of the quality of annual reports in Indonesia, to avoid a negative image of the company's transparency, the Board of Directors of *Bintang* on its website (front page) made a claim as follows:

> In the 2004 annual report award competition, *Bintang* was in 6th position and... was still in the highest position among insurance companies... Our commitment is to be the best, in 2002 we were in the first position, 2003 we were in the 4th position, and now we were in the 6th position. It is our commitment to be in the first position in the next annual report award competition (My translation)[38].

Efforts conducted by the Board to publish quality annual reports are intended to persuade those who are interested in insurance business to support what *Bintang* has currently conducted in running such a business. In other words, *Bintang* seeks support for its legitimacy. Consequently, corporate financial reporting is used by *Bintang* as a means of gaining legitimacy by informing readers that the company's values, beliefs, norms and practices are in congruence with socially accepted values in the community in which *Bintang* operates.

In regard to Javanese views on an ethical social relationship, the case of *Bintang* showed that information presented in financial reporting is intended to avoid social conflict. In other words, financial reporting is used by *Bintang* as a

[38] Accessible on http://www.asuransibintang.com/scripts/news/newscontent.asp?newsid=71 (accessed on 24 July 2005).

medium that *Bintang* do not break Javanese norms and value (respect and conflict avoidance). Because behaviour in accordance with socially accepted beliefs, norms and values is a part of maintaining social harmony in the Indonesian society (Magnis-Suseno 1997), the way *Bintang* is committed to quality financial reporting practice means that gaining legitimacy is eventually directed to maintaining social harmony. The following section will discuss the relationship of corporate financial reporting and social harmony.

### 6.3.2 Financial Reporting and Maintenance of Social Harmony

As previously discussed, the story of *Bintang* shows that corporate financial reporting, as a medium of business communication, can be used as an attempt to legitimate an organisation action. This is because an annual report supplies information that allows society to assess whether a company complies with socially acceptable norms, beliefs and rules. The ultimate purpose of doing this is to maintain social harmony in a society in which the company operates. Maintaining social harmony means that the company runs its activities that are useful for the society and are always in accordance with the socially acceptable beliefs, norms and rules.

The reason that *Bintang* conducts such practices in this way is because it reflects Javanese culture, which is dominant in Indonesia. This claim is consistent with some studies in accounting concluding that there is an association between corporate financial reporting, cultural contexts (Adams and Kuasirikun 2000) and ethical relativism (Lewis and Unerman 1999). To quotes Adams (2002, p. 228), "moral values, themselves influenced by the various components of culture, should have a greater impact on ethical and social reporting...". Because Javanese culture greatly influences a social relationship in the Indonesian society, it can be argued that Javanese culture also affects financial reporting practice of *Bintang*.

The core value of Javanese culture is maintenance of social harmony in a social relationship. Since *Bintang* operates in a society that strongly considers the importance of social harmony, the financial reporting practice of *Bintang* is directed to achieve such harmony. This can be seen from the fact that *Bintang* has been run under a family-type management. Within this management philosophy, tolerance and solidarity play important roles in maintaining social harmony. In doing so, individuals work based on the concept of "*gotong royong*", referring to a philosophy that people must help each other. This implies that in conducting business, *Bintang* cannot neglect the social and institutional environment in which its activities take place. The success of *Bintang* is because of collective actions involving the society.

As *Bintang* is surrounded by religious individuals and communities, in financial reporting, *Bintang* always mentions its contributions to social and religious activities. This can be seen from statements in the 2001 annual report (p. 40):

> As has been outlined in business ethics, the company should give positive contributions to the surrounding community where the company operates. One of the company contributions to the community is to support social activities with donations. Besides that, it has been a routine activity for the company to donate animals to the society around the head office on every *Idul Adha*[39] together with distribution of foodstuff. [Another] important social activity is giving scholarships to high-achieving children of employees.

Furthermore, for the purpose of showing that *Bintang* operates in accordance with the social values, annual reports of *Bintang* always deliver messages related to its contributions to the social environment, for example:

> The spiritual activities, sport[ing] activities, and other social activities are coordinated by the SPBA [the labour union of *Bintang*] and supported by the company (2001 annual report, p. 39).
>
> To maintain social and environmental equilibrium, the company adopts an ongoing effort as a participator in the development of social and community environments (2002 annual report, p. 47).
>
> As part of the realisation of the measures reflected by its business ethics, the company at all times makes every possible positive contribution to the environment where it operates...For the purpose of maintaining social and environmental balance, the company makes a continued effort to participate in the construction of a social environment (2003 annual report, pp. 45–46).

How *Bintang* has practised financial reporting is an example of the influence of Javanese values (the maintenance of social harmony) on such practice. Quality financial reporting is published in order to maintain social harmony, rather than simply to provide useful information. Financial reporting has been used as a medium to communicate an organisational reality of *Bintang* to the

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[39] *Idul Adha* is a day in the Islamic calendar on which Moslems go to the Holy City of Mecca (Saudi Arabia) to make pilgrimage (*hajj*). During this day, Moslems around the world, both those who go to Mecca and those who do not, attend a mosque for praying. As part of the celebration, animals (usually goats, lambs or cows) are slaughtered and acknowledged as a sacrifice to *Allah* (Adnan 1997). The meat then is distributed to the poor or needy as a practical demonstration of brotherly concern between believers.

Indonesian society that *Bintang* does not break social harmony. As Coy and Pratt (1998) note, an annual report plays an important role in communicating and shaping the reality of the organisation in the public's mind. How this reality is perceived depends in part on the extent and quality of information provided in the annual report. In this regard, the Chairman of the Board of Commissioners, in his message in the 2001 annual report (p.14), said:

> ...the Board of Commissioners believes that *Asuransi Bintang* has positioned itself on the right track in welcoming in the globalisation era...We highly appreciate and support the Board of Directors...in coping with public trust and especially that of shareholders and stakeholders.

The story of *Bintang* indicates that financial reporting is designed by management to tell the truth about the company in order to avoid a social conflict and to persuade members of a society and its stakeholders that *Bintang* conducts an ethical business. The head of the Internal Audit Unit on 9 September 2004 pointed out that:

> …a quality annual report is very important for *Bintang*. Indeed, *Bintang* is a publicly listed company. What I mean here is that how *Bintang* is transparently able to report its performance constitutes the accountability of *Bintang* to the public. So it is very important to *create an image that Bintang does not betray the public in regard to information being published*...All decisions are made by committees and no one dominates any decisions. Any decisions and policies are accountable. (My translation; emphasis added.)

The Board of Commissioners also supports the fact that fair presentation of annual reports is consistent with the need for maintaining social harmony. In the 2002 and 2003 annual report the Board said:

> The commitment to implement "good corporate governance", which...has become characteristic of the corporate culture of *PT Asuransi Bintang Tbk*, is an exemplary added value within the fading era of "virtues and values" in some of the social structure of our society. We consider this as another form of dividend paid by *PT Asuransi Bintang Tbk* to all its shareholders who have given their trust all this time (the 2002 annual report, p. 2).
>
> ...Becoming "the most profitable insurance company for all stakeholders and a professionally managed company which complies to the GCG [good corporate governance] standards"...will benefit our society, especially our business environment, including the insurance industry in Indonesia (the 2003 annual report, p. 17).

Furthermore, the Board of Directors wrote a message in the 2003 annual report (p. 19) that:

> Notwithstanding the failure to reach targeted sales and earnings figures, the company continued to comply with the provisions of applicable insurance law...

As obeying regulations is an essential part of society's values, *Bintang* always claims in its annual reports that the company complies with any governing regulations and rules—even though, from a performance perspective, the company may not be successful in achieving a certain target. Convincing evidence showing how *Bintang* always obeys any regulations for the purpose of maintaining social harmony can be seen in the 2003 annual report. In delivering messages regarding obedience, *Bintang* uses the following texts (pp. 44–45):

> In September 2003 the government issued new regulations concerning the insurance industry through six Ministry of Finance decrees simultaneously...The company declares its support to these decrees for the purpose of ensuring that insurance companies are led and managed by proper personnel...

Furthermore, in regard to the success of *Bintang* in wining the annual report award competition, the President of the Board of Directors on 16 September 2004 claimed that:

> …the annual report award is very important for my company. The award shows the public that my company is really transparent and *always complies with regulations.* (My translation; emphasis added.)

This statement means that such an award is mainly used to tell society that *Bintang* is always in congruence with any regulations, and shows how *Bintang* portrays its activities for the purpose of maintaining social harmony.

*Bintang* is committed to such financial reporting practice because it can be used to build "an image of the corporation that ingratiates it with its stakeholders" (Stanton, et al. 2004, p. 59), so as to obtain approval by conveying compliance with the normative rules of the institutional environment (Dowling and Pfeffer 1975). Moreover, as Allen and Caillouet (1994) posit, by self-promotion, acclaiming the corporation's roles, including that of being socially responsible, a company asserts its appreciation for institutional norms and values. What *Bintang* has done in its annual report is to declare its support and compliance to institutional norms. In Javanese context, financial reporting practice is performed by *Bintang* to show that the company are always compliant with Javanese values (conflict avoidance and maintenance of social harmony). As such, financial reporting is designed as a rhetorical story to attract those interested in company activities. The next section will analyse how financial reporting is designed as a rhetorical story to persuade audiences.

## 6.4 FINANCIAL REPORTING AS A RHETORICAL STORY

The previous section discussed how an organisation is considered legitimate to the extent to which its means and ends are in accordance with social values, norms and expectations. As financial reporting is seen as a means of communicating information to society, financial reporting practice can be designed by powerful actors to construct rhetorical stories about the organisation's actions by claiming that the organisation complies with socially imposed beliefs about how the organisations should act. Corporate financial reporting can comprise different stories. They comprise discourses directed to the past, present and future of corporate activities. They also address recurrent problems.

The term "rhetoric" is appropriate in any case where the medium of an organisation to communicate its activities is a language. As financial reporting is a part of accounting activities and seen as a business language, it is reasonable to claim that an annual report is a rhetorical story—a story about company activities intended to persuade outside parties to support the company's existence. The importance of a language is also supported by Arrington and Schweiker (1992, p. 515) who argue that:

> …accounting, like other social practice, is rich in meaning: complex, multifaceted, historically fluid, and variant with the particularities of individuals, values, interests, institutions, histories, modes of practices, and consequences in which accounting acts are situated.

In addition, accounting language is rhetorical because it argues and persuades like any other discourse (Thompson 1991).

Before discussing annual reports as rhetoric, it would be useful to discuss what rhetoric constitutes. Such a discussion is important because rhetoric can be interpreted differently, from bombastic and misleading language devices to argumentative language devices.

### 6.4.1 What is Rhetoric?

The word rhetoric has been widely cited in discussing politics and communication. In general, rhetoric is seen as a term dealing with the use of both written and verbal language to persuade an audience. In the *Oxford English Dictionary* (1992), rhetoric is defined as:

> The art of using language so as to persuade or influence others; speech or writing expressed in terms calculated to persuade or impress (often in a deprecatory sense); language characterised by artificial or ostentatious expression.

In this definition, rhetoric refers to a language that is intended to persuade someone to feel, think or do something for an ostensible reason when the actual reason is different.

Similarly, Hopper and Pratt (1995, p. 11) describe rhetoric as a form of persuasive or effective speech or writing that is intended to control a reality, and is used to obscure real meaning—even to "promote ambiguity". Hence, rhetoric is used to signify a language that might be intended to mask a reality in order to seduce compliance and consent.

Rhetoric involves monologue and texts. In addition, rhetoric has been generally understood to be a unilateral process by which a speaker undertakes to persuade an audience.

However, it should be noted, as Carter and Jackson (2004, p. 470) claim, that "rhetoric is not just an unfortunate epiphenomenona of language use, but a total system of persuasion, reinforcement and reassurance". Even though rhetoric has been described as an art, it can be seen as a process of argumentation and persuasion (Carter and Jackson 2004).

### 6.4.2 Rhetoric as a Process

Rhetoric, as a process, has a certain characteristic. Perelman (1982) proposed two key characteristics of rhetoric: style and context.

#### 6.4.2.1 Style in Rhetoric

The first characteristic of rhetoric is "style", which involves a choice that a rhetorician makes in the way that an argument is presented. As style concerns presentation, rhetoric will be greatly influenced by the ability of the arguer in presenting arguments (Carter and Jackson 2004). In this regard, it is useful to consider what Arnold (1982) and Perelman (1982) argue about factors that are mainly significant in style of rhetoric. The factors can be described as follows:

a. The argument is informal, by which it does not aspire to or adhere to the rules of formal logic. This means that rhetoric deals with concepts that cannot be justified in a way that satisfies the standards of proof of formal/scientific logic[40]. Indeed, rhetoric is value laden, rather than morally neutral.

[40] Examples of these concepts include excellent, quality, satisfaction and effectiveness, which are subjective and abstract concepts that are not amenable to definition by the rules of formal logic. They represent and prioritise selected values advocated by those who propose them (Carter and Jackson 2004).

b. To have any kind of hope of persuading, rhetoric should be presented as a challenge to the ideological predisposition of those to whom it is addressed. This characteristic means that rhetoric must have acceptability. In other words, rhetoric must be used in accordance with socially accepted beliefs, norms and rules. Hence any changes made in the language of communication must be socially acceptable.

c. Rhetoric is irredeemably ambiguous and open to interpretation. This means that in rhetoric, the list of pivotal concepts of which no generally accepted definition is available is almost endless (Carter and Jackson 2004). In financial reporting, for example, there is no general agreement on what constitutes quality annual reports. It depends on the points of view used by those who interpret the reports.

d. Rhetoric is composed of identifiable linguistic techniques, which link together preferred concepts and attitudes and underplay others. Arnold (1982) and Perelman (1982) illustrated such techniques as follows:

    1. Quasi-logical arguments that claim to be rational because they resemble a pattern of formal reasoning.
    2. Arguments that are based on claims concerning the structure of a reality.
    3. Argument based on examples, illustration and models, all of which imply and allegedly represent the operation of overriding rules or laws or principles.

4. Clarification of one idea (theme) by associating it with another, as in analogy or metaphor.
5. Processes by which some feature of an idea is detached or dissociated from it so that the primary idea can be seen as without objectionable or incompatible features.
6. Amplification or abridgement of ideas or values.
7. Imposing special orders on ideas or arguments.

The use of style in rhetoric is eventually influenced by a contextual factor. In other words, it is the audience that determines what kinds of rhetoric that will be constructed by designers.

#### 6.4.2.2. Context in Rhetoric

The second characteristic of rhetoric is “context”, referring to consideration of a particular situation in which the argument is made. Thompson (1991, p. 598) argues that “what is said, how it is said, and why it is said...need to be placed in its contingent institutional context”. Hence, a context in rhetoric deals with a particular situation in which an argument is made. In other words, arguments are addressed to an audience. Indeed, an audience is the context of stylistic techniques that is extremely important to the rhetoric (Carter and Jackson, 2004). Pelerman (1982) believes that there are two kinds of audiences to which rhetoric is addressed: the *universal*, which includes everybody who is unlikely to be convinced; and the *particular*, which comprises fewer than the universal and is made up of those who can be, and are likely to be, persuaded.

To whom persuasion will be directed is a matter of a speaker's construction. It is claimed that a universal audience is the most difficult one to address. Thus, rhetoric is mostly directed to a particular audience. The rhetorician must adapt to the particular audience and can only argue in accordance with the ideas and concepts already accepted by the audience (Carter and Jackson, 2004). According to Perelman (1982), the point of arguments is to secure or to reaffirm adherence—not to convince an audience of a truth which must be accepted notwithstanding previous beliefs. In other words, the process of rhetoric is not to challenge beliefs, but to reinforce them.

This section discussed what constitutes rhetoric. To understand the rhetoric of financial reporting, the next section will analyse financial reporting practice in *Bintang* as an example of why corporate annual reports are designed as rhetorical stories.

## 6.5 DESCRIPTION OF FINANCIAL REPORTING OF *BINTANG*

To analyse annual reports of *Bintang*, this study uses three annual reports that were entered in the annual report award competition: the 2001, 2002 and 2003 annual reports. Beside the fact that such reports were the most currently available at the time field research was being conducted, the 2001 annual report won the annual report award competition, whereas the 2002 and 2003 annual reports were ranked fourth and sixth respectively.

Corporate annual reports might be divided into two sections: the first containing graphs, pictures and narrative texts, and the second describing financial figures and fewer narrative texts.

### 6.5.1 The First Section of the Annual Report: Building Company Image

The first section of the annual financial report of *Bintang* consists of a colourful cover, and graphics, pictures and narrative texts describing a profile of the company, with messages, management discussion and analysis.

#### 6.5.1.1 The Cover: Discerning the Corporate Message

The cover of annual reports is often designed to describe an image of a company. The covers of the annual reports of *Bintang* uses different pictures, designs and captions to covers the current condition of the company. According to Preston, et al. (1996, p. 115) such images and captions show that annual reports are "a visual medium through which corporations, one of the principal political, social, and economic institutions of the twentieth century, attempt to represent and...constitute themselves".

The 2001 annual report cover is characterised by a picture of an eagle carrying a flower and flying above layers of bricks. The caption reads: *"*Start with a Piece of Commitment and Integrity to Build Trust*"*. This report was intended as a testimony to *Bintang*'s commitment and integrity, so the picture and caption are visual representations of the way that *Bintang* has a commitment and integrity to build trust with customers and to protect them. In the 2001 annual report, *Bintang* claimed (p. i):

> The layers of bricks describe the activity of building something...[to represent] the verb 'to build'...The process of brick laying into a building demands prudence. It can be further interpreted that the building will give shelter to anybody inside it.
>
> A flying eagle carrying a flower in its claws symbolises the service quality of *PT Asuransi Bintang*. An eagle symbolises something robust and invulnerable. The flower has a philosophical meaning of providing the best services at all times.

The pictures and captions on the cover of the 2001 annual report are different from those of the 2002 and 2003 annual reports. The cover of 2002 annual report has a picture of a warrior and a star with a caption reading: "...to Serve and Protect". *Bintang* claimed that a warrior in an upright position reflects "the strong determination and commitment of Bintang to serve and to protect its clients from the risks of financial losses by providing quality [insurance] products and services" (p. i). The warrior who is wearing an armoured-war uniform is intended to represent the readiness and consistency of *Bintang* in coping with increasing competition in the insurance business. The image of a star represents an element that strengthens the company identity.

A different picture and caption can also be seen in the 2003 annual report, where the condition of *Bintang* is visualised by a historical, monumental building, which was supported by large pillars and with a caption reading: "Stronger for Your Protection". This picture symbolises the firm foundation of *Bintang* to show the abilities of the company in coping with a competitive insurance business. The strong pillars represent the commitment of management to maintaining the credibility of *Bintang* in delivering the best services to customers.

The use of such pictures and captions aims to tell the audience about *Bintang*. Of course, how the audience perceives *Bintang* depends on their interpretation of the pictures and captions. Barthes (1964, p. 40) believes that "in advertising, images are presented with a view to the best reading; its meaning is intended to be clear or at least empathic" (quoted by Preston, et al. 1996). In the annual reports of *Bintang*, there are definite attempts to communicate an empathic message and relate the image to a particular corporate attribute. Photographs or pictures within annual reports do not reflect how people behave, but how one thinks they behave (Anderson and Imperia 1992). In addition, photographs or pictures are used to lend credibility to the report (Graves, et al. 1996) and are intended to persuade readers (Simpson 1999).

In regard to different pictures and captions on the covers of annual reports, the Directors of Financial Services who is responsible for producing annual reports, on 24 August 2004, explained as follows:

> each year our annual reports have different symbols, mottos [captions], and styles of presentations...We have reasons for doing this. First of all, we want to express the experience of *Bintang* in the annual report. Because *Bintang* has experienced different challenges in doing business we put different pictures and mottos [captions] on the reports. Second, it relates to a style of design. For example, we believed that in 2004 *Bintang* would make good progress in the insurance business. Thus, we put a picture of strong pillars on the cover of the 2003 annual report and wrote a motto: "Stronger For Your Protection" on it (*my translation*).

This explanation shows that financial reporting uses rhetoric intended to persuade the audience. However, it can be argued that the literary devices used by *Bintang* are not intended to manipulate the real facts. Instead, *Bintang* has tried to portray the "true picture" of its activities.

#### 6.5.1.2 Narrative Texts: Looking Beneath the Surface

Besides pictures and captions on covers, the first section of a corporate annual report also comprises narrative texts, graphs and pictures. The 2001 annual report of *Bintang,* for example, contains fifty pages of narrative texts, tables and graphs imparting messages from the Board of Commissioners and the Board of Directors, the history of the company, business risks, opportunities and threats, description of powerful staff members, ownership structures, and an analysis and discussion of company performance.

In general there are no significant differences in the annual reports of *Bintang* for the years ended 2001, 2002 and 2003 in terms of the information disclosed in this section. The difference lies in the form of graphs and tables. For example, the 2001 annual report used a one-line chart and five graphs, made up of conventional rectangle bars. However, in the 2003 annual report *Bintang* used pillars to form the graph. Some pictures were also included in the year of 2003, but not in 2001 and 2002, for example, pictures of insurance products. Interestingly, all members of the Board of Commissioners and Board of Directors signed the 2001 report, but not the 2002 and 2003 ones.

It is important to note that narrative texts significantly dominate the first sections of the annual reports. Most of these discuss management views in regard to company performance, insights into the future and management capabilities to run the company. For example, the 2001 annual report (p. 17) states that:

> The company achieved targeted premium income whereas the net profit after tax decreased and was lower than that of the previous year but only 4% below projected profit.
>
> The negative growth of premium income in 2000 resulted in a significant increase in the unearned premium reserve in 2001. Another factor that decreased the 2001 profit was an increase in incurred claims. Both factors are the main causes of a decrease in the company's underwriting result.

These statements are mainly intended to justify the reasons for a decrease in company performance. In addition, when describing the 2002 company plans, the Board of Directors wrote an analysis in the 2001 annual report (pp. 49–50) as follows:

> The undue recovery of the nation's economic situation [that] is worsened by the tragedy on WTC New York on 11 September 2001...has brought along additional burdens to the national insurance companies, which are endeavouring to prepare themselves for the forthcoming AFTA where the level of competition will be tougher.
>
> Notwithstanding the above situation, we can be proud that the company is able to renew all treaty programs for 2002 without any shortage in reinsurance protection... Amazingly, the company is able to have reinsurance protection for sabotage and terrorism risks which have disappeared from the Indonesian market (and from the market in certain countries). This enables the company to provide clients with a whole range of protection...
> .

To support what has been done by the Board of Directors, the Chairman of the Board of Commissioners in his message to shareholders in the 2001 Annual Report of *Bintang*, (p. 13) said:

> ...what the management of *Asuransi Bintang* has done in 2000 in giving first priority to the enhancement of "Credibility" and "Service Quality" within the framework of Good Corporate Governance is a forward looking policy. As a consequence of this policy, we observe, the increase in operating expenses resulting in the decrease in the profitability by 31% in 2001 compared to 2000 is reasonable as this situation has been mainly caused by the significant increases in the claim cost and unearned premium reserve.

These texts are intended to provide an argument and explain the logic of the causes of success and failure of *Bintang* in managing resources entrusted by stakeholders to its management. In this regard, on 7 September 2004 a manager (Mr C) in the Accounting Division who previously worked at one of the "big five" accounting firms in Indonesia claimed that:

> *Bintang* also discloses information voluntarily. For example if we gain tax returns, we will make a note on the related accounts. Or... we can provide additional narrative texts to tell certain important information. These will allow users to gather more information than they need, so it is not necessary for them to raise questions to *Bintang.* (My translation.)

Similarly, the head of the Internal Audit Unit, on 9 September 2004 believed that:

> We always attach voluntary explanations of any items that we consider important for users to know. This is part of our commitment to transparency. We always try to disclose any information as transparently as possible. (My translation.)

These statements are supported by the Director of Financial Services, on 24 August 2004, who pointed out that:

> A voluntary disclosure is an automatic process. I mean if we think that such a disclosure is important and makes financial reporting more useful we will do that. By so doing, we wish that users or readers will be encouraged to know more about our company. (My translation.)

The above statements demonstrate that *Bintang* has used narrative texts to describe the company's efforts and accomplishment below the surface in the insurance industry.

### 6.5.2 The Second Section: the Statutory Form of a Rhetorical Story

The second section of the 2001 annual report consists of 57 pages of statutory materials. This section includes six reports/statements: an audit report, a balance sheet, a statement of income, a statement of changes in stockholders' equity, a statement of cash flow and notes to the financial statements. There are no graphs or pictures on this section but narrative texts are still included, especially in the notes to the financial statements, to help users understand accounting policies used by *Bintang*.

In the audit reports, *Bintang* always requests that external auditors put the name of the international audit firm with which the local auditors are affiliated on the heading of the report. As a result, all audit reports concerning *Bintang* financial statements are always written by the external auditors, including the name of the international audit firm. This request can be seen from a discussion in the Audit Committee meeting on 25 September 2002. The Chairman of the Audit Committee asked the external auditor to include the name of the international auditor in any papers used in correspondence:

> In an engagement letter, the audit committee saw an unclear statement that needs further clarification from the external auditor. It should be clearly stated that any matters related to correspondence and reports must be written on the paper with the logo of "Ernst & Young International Ltd", not just the "*Prasetyo Utomo*" Audit Firm. (My translation.)

Furthermore, on 10 October 2002 the Audit Committee and the Board of Directors had another meeting with the external auditor to finalise the engagement letter. In this meeting, the Audit Committee asked the auditor about a change in the international partner from Arthur Anderson to Ernst & Young. In reply to the question, the external auditor explained that a change in the international audit firm is mainly due to the fact that the credibility of Arthur Andersen had been questioned after the firm was involved in the Enron scandal. A change in the affiliated partner is considered important by *Bintang* because such a change can deliver a certain message to its audiences and can be differently interpreted by the audiences.

Other financial statements, such as balance sheets and income statements, are not different from those of other companies. Part of the *Bintang* financial statements that provides narrative text is in a note to financial statements. This section clearly tells a story how *Bintang* uses accounting policies and complies with regulations. For example, in the Summary of Significant Accounting Policies in the 2001 financial statements, note 2a: Basis of Financial Statement, it is stated that:

> The financial statements have been prepared on the historical costs basis of accounting, except for investment in marketable securities... in conformity with *generally accepted accounting principles in Indonesia*. The financial statements are presented in accrual basis, except for statements of cash flows [emphasis added].
>
> The statements of cash flows present the receipts and payment of cash on hand and in banks classified into operating, investing and financing activities. Effective on 1 January 2000, cash flows from operating activities *are presented based on Decision Letter of BAPEPAM No. Kep-06/PM/2000 dated 13 March 2000 on the amendment of Rules No. VIII.G.7 "Guidelines in the Presentation of Financial Statement* [emphasis added].

Another example can be seen from property and equipment accounts, an account that can be easily modified to smooth periodic income. In the note 2e of the 2001 financial statement regarding the property and equipment account, it is stated as follows:

> In accordance with the Finance Minister Decree No. 384/KMK.04/1998 dated 14 August 1998, as of 31 December 1999, the Company revalued its land and buildings. The revaluation increment of Rp. 29.329.142[.000] represents the difference between fair market value and the accounting net book value of the related property and equipment as of 31 December 1999, which was counted after considering a tax effect. This revaluation increment is presented as a separate account in the stockholders' equity of the balance sheet. In 2000, part of the revaluation increment amounting to Rp. 28.749.997[.000] has been capitalised to share capital.

Because asset revaluation influences other accounts, *Bintang* also makes notes to the affected accounts. For example, in note 18 of the 2001 financial statement *Bintang* is as follows:

> In accordance with the Government Regulation No. 45/1986 dated 2 October 1986, as of 1 January 1987, the company has also revalued its property and equipment (except for land) acquired through 12 September 1986. The revaluation increment of Rp 434.820 (approved by the Tax Authority) has been capitalised to share capital.

These examples show how *Bintang* is committed to quality financial reporting practice by complying with regulations. The numbers and narrative texts are used as a story to tell the truth about a company's condition.

The case of *Bintang* shows that financial reporting delivers messages to its audiences through the use of numbers, pictures, graphs and texts. These messages are mainly intended to persuade those who are interested in the financial reporting of *Bintang*. In line with narrative texts written on annual reports, it is important to note that financial reporting is characterised by serious texts, which use understandable and formal language. Indeed, it is difficult to find *any* unnecessary words, phrases and sentences.

In annual reports, as Preston*,* et al. (1996) argue, certain phrases typify the rhetoric of designers. Such phrases are intended to send the right messages to mirror the bankable value of a company (Pettit 1980), to overcome conflict among external perceptions of the company (Howard 1991), or to frame the way various members of the public know or feel about the company (Hood 1963). The right messages might be directed to enhance the story of a company's performance contained in the financial statements. Finally, annual reports might also deliver messages aimed to address social and environmental concerns.

## 6.6 RHETORIC AND TRUTH IN ANNUAL REPORTS

Understanding the definition of rhetoric will lead questioning about whether annual reports are used as a rhetorical story to mask the reality of the company. The current belief about rhetoric is that language is used to persuade an audience by masking a reality with literary devices and wordy flourishes for the purpose of hiding a reality. Thus, in everyday speech, as Thompson (1991, p. 578) notes:

> …'rhetoric' has connotations of bombastic demagoguery. It is the device of the less than honest politician in his or her attempt to manipulate the political arena. It is associated with a disreputable practice of propaganda and cajolery, involving flowery diction and empty figures of speech.

However, it can be argued that rhetoric does not always connote such views. Indeed, rhetoric can be seen from a positive side. In this study rhetoric has a different meaning and application from those of current commentators. This is because the rhetoric of financial reporting can be used to gain legitimacy by employing a substantive strategy rather than a symbolic strategy.

### 6.6.1 The Positive Side of Rhetoric in Financial Reporting

It is claimed that to gain legitimacy a company can choose two approaches: substantive management and symbolic management (Ashforth and Gibbs 1990). If a company chooses the first approach, the company will use a language device to convince an audience about the truth of the company's activities. Young (2003) rejected a view that rhetoric is a mere addition, a flourish, and a deliberate attempt to trick the simple or weak-minded. He views rhetoric the opposite way from the current commentators. Young (2003, p. 623) argues that rhetoric is:

> …a pervasive element within our lives as we argue with and attempt to persuade others and ourselves of the viability, credibility, and plausibility of our positions, beliefs, problems, solution and perspectives. Through persuasion, significances and meaning are established in our lives as well as in the more specialised arenas of politics and policy making...mathematics...and economics.

Within this context, rhetoric can be argumentative language describing a reality and used to persuade an audience. Rhetorical techniques are resources that are drawn on in efforts to persuade others about the "correctness" of a particular view of reality (Young 2003, p. 623). This implies that rhetoric tends to be argumentative.

Young's arguments show that the central point of rhetoric is more concerned with the way arguments and conversations are conducted in an attempt to persuade, rather than to manipulate facts or information. Rhetoric sees argumentation as a social activity and focuses its functional design of language on managing a controversy and disagreement (Young 2003). Consequently, rhetoric locates rationality of argumentation in the process of overcoming doubts and answering objections. This involves aspects of morality and emotions in those who are arguing. In this regard, Thompson (1991, p. 578) argues that:

> Three distinct but not separable forms of argument have been traditionally deployed here, it is suggested: ethical appeals (*ethos*) involving one's own values and one's own character, emotional appeals (*pathos*) involving an appeal to the feelings of the audience; and rational appeals (*logos*). The preparation of, and reflection on these kinds of appeals is known as the invention of the arguments [original emphasis].

Considering such views and arguments, it is believed that corporate financial reporting can be used as a rhetorical story to persuade ethically stakeholders to support company strategies and goals. This argument is consistent with arguments by other scholars who see accounting practice as rhetoric. Covaleski, et al. (1995), for example, believe that "...accounting is not only an instrument for representing economic reality...but also a rhetorical device for setting forth..."

Moreover, Nahapiet (1988, p. 355) concludes that accounting is a language for discourses, a set of rules for negotiating an understanding or an organisational reality and a mechanism for establishing and maintaining the legitimacy of social actions. An example of the use of rhetoric can be seen from a message by the Board of Commissioners in the 2003 annual report of *Bintang* as follows (p. 17):

> The year 2003 was the year of changes and rearrangement, marked with two events of Board of Directors change, followed by changes in their subordinates functions, responsibility and duty, as it is reflected in the new organisational structure...It is understandable at this early stage that the changes affected the company's performance...

This statement shows that the decrease in performance is not a major problem for *Bintang* because the decrease is caused by important changes in the organisational structure.

The reason why financial reporting can be used as a rhetorical device of communicating a reality is that financial reporting, as a part of accounting activities, can be interpreted in different ways by using argumentative language. In the case of *Bintang*, the Director of Financial Services on 24 August 2004 agreed with the importance of language in annual reports. He claims that:

> I see quality of an annual report from its completeness and the way the annual report is presented including wording used in it...When I read the annual report of *PT. Aneka Tambang, Tbk*[41], the presentation of the report is excellent. Even though I am not an employee of *Aneka Tambang* and do not understand the mining industry, I enjoyed reading the report and found it easy to understand ...For me the use of language in annual reports is important because it motivates readers to know about a company. (My translation.)

This statement implies that all narrative texts, including those stated in corporate financial reporting, are the result of conscious deliberation by knowledgeable individuals. Hence, it is necessary to understand why texts are written and at whom they are directed.

Texts motivate certain beliefs and behaviour (Young 2003). Any arguments, justifications and values contained within them are intended to tell the

[41] *PT. Aneka Tambang Tbk* is a mining company that was awarded as a listed company with the best Annual Report in 2002.

audience about what the writers believe, and should persuade the audience to accept a particular viewpoint or undertake particular actions. In fact, as Young (2003, p. 626) argues, “facts are marshalled and arguments are presented, considered, and disposed”. They are intended “to make a point or argument, to present a concern or to serve as a reason to accept a position or to act” (Young 2003, p. 626). Thus, rhetoric in this study is telling the truth about an organisational reality by providing argumentation and logic.

### 6.6.2 Telling the True Reality of an Organisation

Financial reporting does not merely discuss accounting numbers. It also contains serious texts, because it uses lengthy sentences and formal language describing what happened in the past and what the company will achieve in the future. Even though annual reports are not the only source of information about the performance of a company, annual reports are considered as significant sources due to wide coverage and availability of annual reports (Hooks et al. 2002).

The annual report is a comprehensive communication intended to make company information easily and routinely available in a single document (Hook, et al. 2002). The annual report is a multi-objectived and multi-audienced communication (Anderson and Imperia 1992). The potential audience of annual financial reporting is “composite” (Myers 1999). Annual financial reporting is not only required by shareholders, but also read by competitors, suppliers, customers, regulators, the press and other parties interested in the annual financial report.

Although this mass communication has so many intended recipients, the main audience is frequently considered to be shareholders (Kohut and Segars 1992; NIRI 2004).

Considering the audience of such reporting, annual reports contain basic information about a company expressed both in financial and narrative texts. The narrative texts are intended to supplement financial information. A combination of quantitative information and narrative data enables an annual report to supply information to those who need it. Hence, narrative texts are becoming increasingly important in external financial reporting. This is particularly important because traditionally, these narrative texts have been unaudited. There is, therefore, potential scope for managers to control and manipulate the impression conveyed to users of accounting information (Deegan and Gordon 1996).

However, it can be argued that the use of narrative texts depends on the designer of corporate annual reports. Indeed, narrative texts can be used to explain or to give an argument in regard to company performance or what the company management has done in running the company. To some extent, the behaviour in writing a necessary narrative text in financial reporting is influenced by corporate culture and the ethical conduct of the designer.

Rhetoric of financial reporting is designed to tell a true story of an organisational reality. Thus it is hard to find any unnecessary language just to mask the reality of the company being described in an annual report. This can be seen from the case of *Bintang* when the Board of Directors made an argument in the 2001 annual report (p. 17) in regard to a decrease in profit. The Board of Directors said that:

> We achieved the targeted premium revenue even though income after tax was lower than last year but it was only 4% lower than the projected income. The negative growth of premium revenue in 2000 led to an increase in premium reserves in 2001. Another factor that caused a decrease in profit in 2001 was the increasing number of claims. Both factors contributed to the decrease in underwriting results

These sentences were used by the Board to explain the causes of a decrease in the income of *Bintang*. There are no wordy flourishes used to mislead audiences. Instead, the report used an argumentative style, telling the truth, to persuade the audience that such decreases are reasonable.

In line with financial reporting practice in *Bintang*, the Director of Administration Services, who is also one of the minority shareholders, on 8 September 2004 claimed that *Bintang* is committed to providing the true information to its audiences. He said:

> ...a good annual report is one that shows accurate information and provides enough narrative explanations of company activities. However, it must tell the truth. *Bintang* has produced such a report. (My translation.)

On 7 September 2004, an ex-external auditor (Mr C) who currently is employed by *Bintang* also confirmed the commitment of *Bintang* to portraying the true organisational reality and said:

> If we compare the annual report of *Bintang* to that of other insurance companies, the annual report of *Bintang* is the best. I mean *Bintang* has presented transparent and informative figures in the annual report. When we read the report we will understand what the figures or information mean . (My translation.)

The case of *Bintang* also shows that financial reporting has provided a unique access to a company's embeddedness in a civic society. This is because annual reports are "the most publicized and visible documents produced by a publicly owned company" (Henriques and Sadorsky 1999, p. 91). In addition, annual reports are intended to "communicate implicit beliefs about the organisation and its relationship with the surrounding world" (Fiol 1989, p. 278). An annual report at least delivers messages of historical performance and an insight into the company's future and management capability (Ind 1997).

#### 6.6.2.1 Historical Performance

In terms of historical performance, annual reports can be used as a device to diagnose past events and to attribute the praise or blame for the events. Indeed, companies usually claim credit for their success but attribute failures to external factors (see Bettman and Weitz 1983; Salancik and Meindl 1984). Narrative texts, as part of language, can be used as a device to show such attribution. Thus, corporate financial reporting, as business language, might be used to obscure distinctions about the causes of poor performance, presenting the company in a positive light (Jameson 2000). For Thomas (1997), language is used to blur attributions. These attributions can be seen as "hedonic bias" (Aerts 1994), showing a general tendency to attribute anything negative to external environmental causes and to attribute favourable outcomes to internal dispositional factors.

In general, some studies (Aerts 1994; 2005; Bettman and Weitz 1983; Salancik and Meindl 1984) have documented a robust tendency to attribute positive results to the company's own actions (company strategies, decisions, human resources, and so on) and negative outcomes to external events (business climate, government regulations, political condition, and so on). Hence, in describing its performance, a company can explain negative performance in either technical accounting terms (Aerts 1994) or convoluted language (Jones 1996). On the other hand, the company can explain good performance in strict cause-and-effect terminology so that management's responsibility for them is clear (Aerts 1994).

The financial reporting practice of *Bintang,* to some extent, might show this phenomenon. However, *Bintang* has conducted such a practice for neither misleading audiences nor hiding true information. Instead, this is part of its honesty and ethical conduct to tell the real story of *Bintang* performance. For example, when describing the history of *Bintang* in the 2003 annual report (p.4) the Board of Directors claimed that:

> One reason why *Bintang* has been successful during the last four decades in the insurance industry is that *Bintang* is always consistent in implementing good corporate governance principles. The spirit to implement good corporate governance has been inherited from the founders of *Bintang* whose idealism was to promote the dignity of Indonesian people through economic and trade activities that were previously dominated by foreign companies. Thus, it is no wonder that *Bintang* has been awarded the Annual Report Award by BAPEPAM from 1980 to 1983 even though at the period *Bintang* was still a private company that did not raise capital from the capital market.

This statement shows that the cause of success was an internal factor, the ability to implement good corporate governance principles.

However, the internal aspect is also mentioned as the cause of a decrease in company performance. For example, in the same report (p. 19) it is claimed that:

> 2003 was a rather tough period to go through. Ever since there was awareness about the decrease in our earnings in 2002 which was specifically due to the growing number of claims, the company made several changes in technical policies...[*which*] have had a direct impact on the decrease in the amount of our premiums.
>
> Internal efforts to improve infrastructure and to apply the principles of good corporate governance... caused a fairly strong contraction and decrease in a number of personnel at several key positions.

The above statements illustrate that internal changes and management ability contributed to a negative performance.

It might be true that, in annual reports, a positive performance provides a powerful signal of managerial competence, and does not necessarily need further explanation to make them consistent with a desired organisational image (Gibbins, et al. 1990). But this does not hold for a negative performance, which has to be explained to make intelligible or legitimate (Scott and Lyman 1968). However, *Bintang* practises a balance in arguments in regard to its historical performance. Indeed, the company has provided explanations to both positive and negative performances. The reason for doing this can be seen from a statement by the President of the Board of Directors on 16 September 2004:

> I think what is meant by a quality annual report is a report that fairly presents what is really going on in the company. We must be honest in reporting information. If our performance is unfavourable we might be able to manipulate data or information to make it look favourable. But we always think...what is the point of doing that? I think it is not necessary for us to manipulate data. If other companies do that, it is their choice. We do not copy such an unethical practice. I always believe that external auditors will find any frauds and irregularities. (My translation.)

The statement by the President of the Board is also reinforced by those who are directly involved in recording a company's transactions. For example, on 21 September 2004 Mr E, who has spent more than 15 years in the Accounting Division said:

> I think *Bintang* never hides any important information. We provide transparent and completed data. What the users need is available on annual reports. (My translation.)

This view is similar to that by Mr F, who also works in the Accounting Division. On 21 September 2004, he claimed:

> We never manipulate data and there is no involvement of top management that forces me to manipulate data. I think the quality financial reporting is determined by the honesty of staff involved in it . (My translation.)

In addition, management always praises the company workforce as an important part of a company's success and consequently, this is mentioned in annual reports. For example, in the 2001 annual report (p. 19), the Board of Directors claimed that:

> With all we have been through and trying to achieve in 2001, the management wish to express thanks especially to all staff and employees of the company who have worked hard, sincerely understood the company's demands and have high commitment to maintain the company's existence, which may bring benefit to the shareholders, management, employees and clients.

The Board of Commissioners also supports the importance of employees for *Bintang*. In the 2003 annual report of *Bintang* (p. 17), the Chairman of the Board of Commissioners concluded that:

> The ability [of *Bintang*] to recover [from the economic crisis] and become a stronger company is not generated by the capital strength, nor by a sophisticated technology, but by the idealistic spirit of our people who always want to enhance their abilities/skills, to make corrections, to make changes and improvement… [for the purpose of achieving an idealistic objective], that is: "Becoming the most profitable company for all stakeholders and a professionally managed company which complies to the GCG [good corporate governance] standards". The realisation of such idealistic objectives will be beneficial for our society and business environment, including the Indonesian insurance industry.

The above statement provides evidence that the annual report is used as a vehicle to exhibit the fact that internal factors and workers' enthusiasm have contributed to the success of *Bintang*.

On the contrary, it can be seen that the cause of failure is to some extent determined by external forces which *Bintang* cannot directly control. For example, in the 2003 annual report (p. 20) it was claimed that:

> The decree issued by the Minister of Finance 30 September 2003 requires earlier payment of premiums, from 90 days to 60 days. Failure to comply with this regulation will result in the fact that the premium cannot be recognised as admitted assets and will consequently decrease our solvency.

This statement implies that it is the regulation that influences company abilities in achieving the level of solvency. However, problems of regulations are faced not only by *Bintang,* but also by other insurance companies. To understand this, it might be important to note what the Director of Administration Services said on 8 September 2004 about the regulation:

> We have very tight regulations in the insurance business, for example, the regulation about risk-based capital (RBC) and admitted assets. This regulation has made the Indonesian insurance business more difficult. When I explained this regulation to a director of a British insurance company, he said to me, "if this regulation is applied in the UK, my company will go bankrupt. The implementation of the regulation is too fast. It is impossible to fulfil the targeted RBC within four or five years". (My translation.)

Statements by parties outside *Bintang* concerning these tight regulations also support such difficulties. For example, Mr Hotbonar Sinaga, the Chairman of *Dewan Asuransi Indonesia*, the Indonesian Insurance Board, insisted that

> The requirement set by the Ministry of Finance [to achieve the level of solvency at 120%] is a major problem for insurance companies. If we count accurately, most insurance companies will collapse because of the regulation. Thus, the regulators should be careful in reviewing annual reports submitted by insurance companies (My translation from *Jawa Pos*, a daily newspaper)[42].

Apropos to the impact of external factors as the causes of negative performance, it is also interesting to consider a statement by a member of the Board of Commissioners at the 2004 Management Annual Meeting of *Bintang* conducted in Bogor, Jakarta on 24 February 2004:

> We are facing a serious problem...We deal with a service activity. We have practised honest business, but our company performance was unfavourable. We have made a wrong conclusion on what we have done. We think that our performance was mainly due to bad luck [external factors]. This is what happens in our company. To improve our performance we must be able to separate those with good conduct from those with bad conduct. We still have a number of employees who are committed to working hard for the benefit of the company and the employees themselves. It is not easy to separate good employees from bad employees, but it is the job of directors (My translation).

This statement obviously explains that blaming negative performance on external factors such as bad luck is not the culture of *Bintang*.

To conclude, it is clear that *Bintang* has used the necessary narrative texts in financial reporting. The texts are designed as argumentative language to tell the true story of historical performance of *Bintang*. There are no literary flourishes

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[42] Source: "Banyak Perusahaan Asuransi Berguguran", *Jawa Pos,* 25 December 2004. Accessible on http://www.jawapos.com/index.php?act=detail_c&id=148009 (accessed on 21 January 2005)

used to mislead audiences. Instead, *Bintang* has utilised argumentative texts in annual reports to persuade its audience that the company performance is determined by both internal and external forces.

#### 6.6.2.2 Insight into the Company's Future

Besides telling a story about historical performance, corporate financial reporting is intended to tell a story about insights into the company's future, and how capable management is of coping with future challenges and threats. Consequently, management usually uses narrative texts in corporate financial reporting to deliver messages concerning risks, opportunities and threats faced by the company. In so doing, management considers internal and external forces that might affect the company's future.

The case of *Bintang* is an example of how management has used narrative texts to deliver messages regarding the company's future. This can be seen from the language it used to describe risks that it might face in conducting insurance business. In the 2003 annual report (pp.10–12) *Bintang* states an expression as follows:

> Natural disasters, such as floods and earthquakes, have occurred lately...even though sound underwriting policies have been accurately set....The possibility of losses and obligation to pay customer claims...due to such disaster will eventually influence company performance.
>
> Regulations require insurance companies to include a currency mismatch in the calculation of solvency...In the condition in which the value of Indonesian *Rupiah* tends to decrease such an inclusion can influence foreign exchange losses
>
> Macro-economic conditions and the stability of national security and politics are uncontrollable factors that might influence the performance of company investment.

The above quotations clearly show how *Bintang* explains external forces surrounding the insurance business, and how such forces might lead to the company's losses. Considering the language used in the annual reports, it can be seen that the above statements are intended to persuade the audience that *Bintang* is facing uncontrollable forces. Such statements show how *Bintang* uses language as a rhetorical device. However, in creating a rhetorical story about the company's future, management also delivers a message about strategies that will be employed to minimise such risks. For example, to minimise technical risks, *Bintang* has set in place a number of strategies, such as setting a sound reinsurance program and establishing a reinsurance committee. In the 2003 annual report (p. 49) it is claimed that:

> A reinsurance program plays a role in assisting the expansion of the company's risk insurance capacity. Through proper reinsurance programs, customer needs for insurance protection may be met...
>
> For the purpose of assisting management with the determination of reinsurance program, the Reinsurance Committee has been set up and assigned to conduct reviews of the current year's program and to determine the reinsurance programs for the following year.

Moreover, in the 2002 annual report (p.4 2) *Bintang* included the following statements to show how it responds to the external forces.

> In response to these economic conditions...the company plans to:
> a. keep providing insurance protection in accordance with market demand, while maintaining prudent underwriting
> b. consolidate the company's operations in order to face global competition
> c. minimise operating expenses
> d. exert efforts to maintain the company's financial health according to the existing regulations.

> Recovery of economic conditions depends on the fiscal, monetary and other measures that have been and will be undertaken by the Indonesian Government, actions that are beyond the company's control. It is not possible to determine the future effects of the economic conditions on the company's liquidity and earnings, including the effects from its customers, stockholders, ceding companies and reinsurance companies.

These messages mean that even though *Bintang* faces a number of business risks, its management is capable of minimising such risks by enacting a proper strategy. In addition, in the 2003 annual report (p. 20), it is claimed that

> ...for the last 14 years, *PT. Asuransi Bintang Tbk*, has provided dividends to the shareholders every year. In this turbulent year, we are apparently still able to uphold our commitment to distribute dividends.

Again, this statement shows that management of *Bintang* is capable of running an insurance business even though the business environment seems not to support the industry. A commitment to the distribution of dividends to its shareholders can be seen as an indication that the management of *Bintang* can be trusted. Within this context, the use of narrative texts in delivering emphatic messages provides a powerful signal of managerial competence.

The management competence in setting proper strategies will influence the extent to which management is able to build a company identity. As corporate identity refers to the "planned assembly of visual cues by which the audience can recognise the company and discriminate one company from another and which may be used to represent or symbolise the company" (Bernstein 1984, p. 63), communication to promote a corporate identity is the purpose of corporate messages. Therefore, written communication is an important part of promoting a corporate identity and contributes to a company's reputation (Schmidt 1997).

The case of *Bintang* shows that the effectiveness of using narrative texts in constructing a rhetorical story for the purpose of communicating a corporate identity depends on the abilities of the key players to provide sound arguments and logical statements in the messages delivered to the company's audience. Finally, it is important to note that corporate culture and ethical conduct will greatly determine and shape the behaviour of management in constructing and delivering emphatic messages, through annual reports, to the audience.

Such practice shows that *Bintang* is committed to the Javanese views of an ethical social relationship by providing information that is true and transparent for the purpose of avoiding conflict and maintaining social harmony. The way of *Bintang* delivers its messages to the audience is consistent with traditional Javanese story, called *wayang* (puppet). Through telling a tale, an actor (*dalang*) delivers messages to an audience about the importance of conflict avoidance to maintain social harmony. In his performance, *dalang* usually uses rhetoric to influence the audience that ethical behaviour is an important part of Javanese life[43].

## 6.7 CONCLUSION

The financial reporting practice of *Bintang* shows that it is intended to seek legitimacy in order to maintain social harmony. Social harmony is seen as

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[43] To discuss the role of *wayang* in the Javanese social relationship see Anderson (1972); Magnis-Suseno (1997); Moedjanto (1990); and Mulder (1994)

the ultimate purpose of corporate financial reporting, because the company operates in an institutional environment that is heavily influenced by Javanese culture. In so doing, *Bintang* has designed corporate financial reporting as a rhetorical story to show fact that *Bintang*'s activities are in accordance with socially acceptable beliefs, norms, values and rules.

The management of *Bintang* also designs the covers of the annual reports with interesting pictures to represent the company's condition. This has been done to build an image of *Bintang* in the eyes of its stakeholders. Moreover, in delivering emphatic messages, *Bintang* has included narrative texts to provide arguments on either favourable or unfavourable performances. Narrative texts are also used to tell a story about an insight into the company's future and management's capability to cope with that future.

Thus, whatever the purpose of writing narrative texts, the case of *Bintang* illustrates that effective communication plays an important role in delivering messages to audiences. This is consistent with claims that regardless of the role of annual reports, as legal obligation (Flanagan 1993), a marketing tool (Rogers and Brown 1999) and an information piece (Kwon and Wild 1994), effective communication only occurs if messages intended by senders through annual reports are the same as those actually interpreted by the receivers (Courtis 1987).

Finally, as corporate financial reporting is a social construction involving cultural and institutional aspects, financial reporting practice in a company becomes a routine of constructing and delivering messages. Because routines are concerned with values shared by organisational members, beliefs, norms, values and rules are perceived as parts of financial reporting practice. Hence, how socially imposed norms, values and rules are internalised in a company will determine the behaviour of organisational actors in constructing an organisational reality through corporate financial reporting as a medium for delivering messages. Successful the institutionalisation of such values will greatly influence ethical conduct of actors, and will drive them to be committed to quality financial reporting practice.

The next chapter will discuss how such norms, values and beliefs are institutionalised in *Bintang* as parts of its corporate culture.

# CHAPTER SEVEN
# INSTITUTIONS, CULTURE AND SOCIAL CONSTRUCTION OF FINANCIAL REPORTING PRACTICE: A LESSON FROM *BINTANG*

## 7.1 INTRODUCTION

Chapter Six discussed how financial reporting practice in *Bintang* was designed by its individuals as a rhetorical story to gain legitimacy and maintain social harmony. The story of *Bintang* shows that financial reporting practice involves interaction between organisational members, the audience and the institutional environment. Through such interaction, financial reporting practice in *Bintang* becomes a routine of constructing and delivering messages.

As a routine, financial reporting practice is strongly influenced by institutions such as regulations as well as beliefs, norms, values and rules, which are shared by the organisational members of *Bintang* in their daily organisational life. Such an institutionalised routine becomes a ritual in *Bintang* and influences the behaviour of the organisational actors through institutionalisation, by which a social construction of financial reporting practice occurs in this company. In addition, as *Bintang* is run under a corporate culture that reflects the Javanese way of life, Javanese culture to some extent shapes (consciously or unconsciously) the behaviour of individuals in the company.

This chapter will discuss institutions that influence financial reporting practice in *Bintang* and how Javanese culture is embedded in the organisational life of the company and drives its members to be committed to quality financial reporting practice. As the Indonesian insurance industry is highly regulated, the first section of this chapter will discuss the regulatory framework affecting financial reporting practice of *Bintang*. The following section will discuss the cultural environment that affect the way *Bintang* conducts insurance business. This will be followed by a section discussing the organisational culture of *Bintang*, which makes the financial reporting practice of *Bintang* different from that of other companies. The next section describes how social construction of financial reporting practice occurs in *Bintang*.

## 7.2 REGULATORY FRAMEWORK

Financial reporting practice in a company never takes place in a vacuum. Instead, such practice occurs in the institutional environment. A legal institutional framework is one factor affecting financial reporting practice—especially that of insurance companies. Morgan (1998, p. 223) claims that "[o]rganizations and the fields within which they compete, cooperate and are regulated are governed by particular rules of action". Indeed, the Indonesian insurance companies, both their management and financial reporting practices, are highly regulated by a number of authoritative bodies, such as the Ministry of Finance, the capital market supervisory agency (*Bapepam*), the Jakarta Stock Exchange and the Indonesian Institute of Accountants. These authoritative bodies promulgate either key governing regulations for all industries or specific regulations for the insurance industry.

### 7.2.1 Key Governing Regulations

The main regulations that influence all business activities and financial reporting practice in Indonesia are those concerning commercial laws. It should be noted that the Indonesian commercial laws are influenced by two systems. The first system is a certain commercial law that has been adopted from the Dutch colonial era. This law is often called *Kitab Undang-Undang Hukum Dagang* (Commercial Code 1847), an adoption from the Dutch commercial code, *Wetboek van Koophandel* 1847. This code governs business activities and has a general requirement that companies must maintain adequate bookkeeping so that a company's financial condition can be determined. However, the code does not clearly state what kinds of books or records must be kept (Kurniawan and Indriantoro 2000).

The second system of regulations comprises laws or regulations issued in the post-independence era. These laws are formulated and issued through presidential decrees or other government agencies. For example, the government of Indonesia issued the Law No 1/1995, *Law on Limited Liability Company*, on March 1996 to replace the corporate law codified in old Indonesian commerce law (*Kitab Undang-Undang Hukum Dagang)* on Book I, Chapter III, Part III, Article 36 to 56.

In relation to financial reporting practice, the *Law on Limited Liability Company* 1995 states that it is mandatory for all companies to publish financial reports in newspapers. This obligation is further regulated in Government

Regulation No. 24/1998, *the Annual Financial Information of Corporation*, which was replaced by the Government Regulation No 64/1999.

According to the Law No. 1/1995, company directors must also present annual reports to the general meeting of shareholders no later than five months after the end of the financial year. In addition, the law mandates the preparation of financial statements in accordance with *Pernyataan Standar Akuntansi Keuangan* (*PSAKs*)—the statement of financial accounting standards[44]. Otherwise, disclosures and reasons for non-compliance must be provided. The law also requires that it is mandatory for financial statements of the following companies to be audited by a public accountant:

(1) companies operating in a field related to mobilisation of funds from the public, such as insurance companies and banks

(2) a company issuing debt instruments

(3) publicly listed companies.

All audited financial statements that have been approved by shareholders must be published in two daily newspapers.

Law No. 3/1982, *Law on Company Registration* is another regulation issued in regard to financial reporting practice. According to this law, the name of the company, date of incorporation, the company's products, details of the board of directors and commissioners, and details of each company's authorised, issued

[44] These standards are set and issued by the Indonesian Financial Accounting Standards Board, *Dewan Standar Akuntansi Keuangan* (DSAK), which was established by the Indonesian Institute of Accountants. Even though DSAK has no legal status as a standard setter, *Bapepam* requires publicly listed companies and the *Law on Limited Liability Company No. 1/1995* requires limited companies to prepare their financial statements in accordance with *PSAKs*. (Appendix 1 shows PSAKs that have been issued by the DSAK.)

and paid-in capital must be reported to the Ministry of Trade and Industry[45]. This law is intended to make company information publicly accessible. Unfortunately, however, this law suffers from some weaknesses. The National Committee on Corporate Governance claims that there is a lack of publicly available information requested by the law, and there is an absence of a timely and accurate mechanism for collection and publication of information (Kurniawan and Indriantoro 2000).

A significant improvement in promoting transparent financial reporting can be seen in Government Regulation No. 64/1999. This regulation replaced No. 24/1998, the *Annual Financial Information of Corporations*, which requires publicly listed companies to file audited financial statements. Regulation No. 64/1999 requires not only a publicly listed company, but also the following companies to file audited financial statements:

(1) companies incorporated under the Law No. 1/1995

(2) companies accumulating funds from the public

(3) companies issuing debt instruments

(4) companies with total net assets exceeding Rp25 billion.

This regulation is seen as promoting more transparent reporting because the regulation requires the audited financial statements, including a list of the company's liabilities and capital participation, to be reported, and requires information to be more easily available through the Internet and in hard copy at a number of local company registry offices (Kurniawan and Indriantoro 2000).

[45] Article 11 of Law No. 3/1982.

Another regulation affecting financial reporting practice of publicly listed companies is the *Capital Market Law* No. 8/1995. One aspect governed in this law is the preparation, presentation and audit of financial statements. This is then supported by *Bapepam* rules that govern transactions or events such as pre-emptive rights, conflicts of interest on certain transactions, mergers and consolidations of public companies and issuers, and disclosure of information that must be made publicly[46].

In general, financial reporting in the Indonesian business environment is regulated by different authoritative bodies. Indeed, publicly listed companies have to submit their audited financial statements to *Bapepam* and the Jakarta Stock Exchange (JSX) 120 days after the end of their fiscal year, and these should be prepared in accordance with *PSAKs*[47]. In addition, the companies are required to submit the statements to the Ministry of Trade and Industry 180 days after the end of the fiscal year. Even though the tax office technically does not require audited financial statements, it is widely known in the Indonesian business environment that it usually asks companies to include the statements when they lodge their annual tax return. Finally, companies in certain industries, such as insurance companies, are also required to submit their annual reports to the Directorate General of Financial Institutions (hereafter the DGFI).

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[46] Disclosure of information by publicly listed companies is regulated in the *Bapepam* Rule No. VIII.G.2 concerning *Annual Report*, which is effective from 17 January 1996, and Rule No. VIII.G.7 *Guidance for Financial Statements Presentation* that is effective from 13 March 2000.
[47] A specific PSAK for the insurance industry is PSAK No. 28 concerning *Accounting for Causality Insurance*, which is effective from 1 January 1996.

### 7.2.2 Regulations on the Insurance Industry

Besides the above governing laws, insurance companies are specifically regulated by the Minister of Finance, and the implementation of regulations is the responsibility of the DGFI[48]. The Minister of Finance has issued a number of regulations on the insurance business. However, the most current regulations relevant for this study are as follows:

a. The Decree of the Minister of Finance Number 421/KMK.06/2003, *Fit and Proper Test for Directors and Commissioners of Insurance Companies*
b. The Decree of the Minister of Finance, Number 422/KMK.06/2003, *Organisation of Insurance and Reinsurance Companies*
c. The Decree of the Minister of Finance, Number 423/KMK.06/2003, *Audit of Insurance Companies*
d. The Decree of the Minister of Finance, Number 424/KMK.06/2003, *Financial Condition of Insurance and Reinsurance Companies*.

These regulations have been issued to replace the previous regulations concerning similar issues. For example, the Decree Number 424/KMK.06/2003 replaces the Decree No. 481/KMK.017/1999 dealing with the financial condition of insurance and reinsurance companies. Even though a detailed discussion of

[48] In certain cases, the DGFI also issues regulations. These regulations are commonly called *Surat Keputusan*–Decisions of the Directorate General of Financial Institutions regulating technical or procedural aspects to supplement regulations issued by the Minister of Finance. For example, when the Minister of Finance issued the Decree No. 481/KMK.017/1999 dealing with the financial condition of insurance and reinsurance companies, the procedure for calculating the financial condition (such as solvency) is regulated in the decision of the DGFI Number Kep.5314/LK/1999.

these decrees is beyond the scope of this study, the following section will briefly describe them.

According to Decree Number 421/KMK.06/2003, the insurance business should be managed by a competent and reliable person. This decree has been issued as a mechanism to ensure that the team governing and managing insurance companies is comprised of competent and reliable people of good character. Consequently, anyone nominated as a director or commissioner must undergo a series of investigations on their character and technical and leadership capabilities to prove that they are fit and proper to conduct thier responsibilities as a director or a commissioner[49].

The second regulation, Decree Number 422/KMK.06/2003, replaces Decree Number 225/KMK.017/1993 to govern the organisation of insurance companies. A part of this decree related to corporate reporting is contained in Article 28 to Article 32. In short, these articles state that insurance companies must submit their annual reports for the period ended 31 December to the Minister of Finance by 30 April of the following year. Forms and structures of the reports are as determined in the decision of the DGFI, Number 1298/LK/2000.

The third regulation, Decree Number 423/KMK.06/2003, *Audit of Insurance Companies,* is aimed at supervising and monitoring insurance companies. According to this decree, auditing is conducted by an officer of the DGFI or other parties appointed by this directorate to ensure the accuracy of

[49] Article 5 of the Decree Number 421/KMK.06/2003.

company's reports and the compliance of the company with governing regulations.

Finally, Decree Number 424/KMK.06/2003, *Financial Condition of Insurance and Reinsurance Companies*, regulates the level of solvency that insurance/reinsurance companies must fulfill and determines elements or factors that must be included in the calculation of solvency. The Minister of Finance strongly insists that to survive in the Indonesian insurance industry, an insurance company must be able to maintain the solvency margin at 120 per cent[50].

Considering the number of regulations relating to the insurance industry, it is open to question whether the regulations are able to improve the governance of insurance businesses and transparency in financial reporting practice. The following section will discuss how regulations have become a problematic issue in Indonesia.

### 7.2.3 Confusing Regulations and Weak Law Enforcement

Even though a number of regulations have been issued to regulate insurance business in Indonesia, it can be argued that such regulations have not been able to support sound business practice and transparency in financial reporting. Indeed, some regulations are confusing and there is a problem with law enforcement.

First, it might be interesting to discuss the regulation concerning *Fit and Proper Test for Directors and Commissioners of Insurance Companies*. This

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[50] The procedure of calculating the solvency margin is regulated in the decision of the Directorate General of Financial Institutions Number Kep.5314/LK/1999. However, it is beyond the scope of this study to discuss technical aspects of such a calculation.

decree looks promising in promoting good corporate governance practice in the insurance industry. Thus, proper implementation of the decree will likely produce an ethical insurance business for the benefit of Indonesian society. However, a classic problem always occurs after the release of new regulations. Indeed, it is easy for the authoritative bodies to issue new regulations but the implementation of the regulations is disappointing. Decree Number 421/KMK.06/2003 requires that, effective from 30 September 2003, directors and commissioners of insurance companies should conduct the fit and proper test. Nevertheless, by 31 December 2004, the decree had not been implemented.

In regard to the issuance of the decree, it might be useful to take into account how *Bintang* responded to the decree. In the 2003 annual report (pp. 44–45) it is clearly stated that *Bintang* declared its support of the decree for the purpose of ensuring that insurance companies are led and managed by proper personnel. Furthermore, at the meeting between the Board of Commissioners and the Board of Directors held on 17 November 2003, it was stated that to support the decree fully, the Board of Directors had applied to the DGFI for such a test. The way *Bintang* responded to the new regulation shows that it was not a problem for directors and commissioners of *Bintang* to take such a fit and proper test.

However, the fit and proper test has not been carried out because the assessment committee responsible for conducting it, as stated in Article 6 of the decree, has not yet been established. In this regard, the Director of Financial

Services of *Bintang* said on 24 August 2004 that:

> This institution was silly. Why has the regulation been issued if it is not clear when the regulation will be implemented? (My translation.)

In addition, on 8 September 2004 the Director of Administration Services argued that:

> I believe that the government agencies issued regulations because they just wanted to explain symbolically to foreign investors that the Indonesian insurance business is safe and reliable. (My translation.)

These statements show that problems of regulation are not only caused by players in the insurance industry but also by the government itself.

The second issue related to problems with thw regulations is Decree Number 423/KMK.06/2003, *Audit of Insurance Companies*. It is clearly stated in the decree that the final purpose of such auditing is to ensure the accuracy of the company's reports and compliance of the company with any governing regulations. However, this purpose, and the audit scope, are no different from those of the annual audit conducted by an external auditor. Hence, this decree overlaps with similar regulations issued by the government and *Bapepam*, which requests that all companies be audited by independent auditors (for example Laws No 1/1995, Government Regulation No. 66/1999—Article 4(2), and the Decision of the Chairman of *Bapepam*. No. Kep-36/PM/2003).

The third issue is a specific and problematic issue regarding regulation of financial reporting practice. Insurance companies are requested to publish two different annual financial reports (the *Bapepam* version and the DGFI version). To some extent, these regulations are confusing and can mislead those who do not understand the insurance business in Indonesia.

To understand how such regulations are confusing, it might be interesting to "listen" to the story of *Bintang*, which was a victim of confusing regulations. The Director of Financial explained on 24 August 2004 as follows:

> We have two forms of financial reports: the *Bapepam* version and the Minister of Finance version. Both are not matched, even though we use the same numbers on the reports. When I wanted to publish a financial report in a national newspaper, I decided to publish the *Bapepam* version. Then I contacted the Directorate General of Financial Institutions to discuss my decision of publishing a financial report according to *Bapepam* and he said to me: "it is okay, no problem". After publishing, I had a disastrous problem. Users of financial reports employed data for their analysis based on financial reports published under the version of the Minister of Finance. Unfortunately, a business magazine (*InfoBank*) used the data and classified my company as insolvent. This was not fair because we could only compare our solvency to that of other insurance companies if we used data presented in the same version of a financial report. The Minister of Finance has a different method of calculating solvency from that of *Bapepam*. (My translation.)

Similarly, the Director of Administration Services said on 8 September 2004:

> There are differences in the classification of accounts in financial reports between the *Bapepam* version and another version. For those who do not understand the insurance business, the regulations might make them face a problem. I mean they could misinterpret the number in the financial reports. *Bintang* was a victim of the confusing regulation because *Bintang* was classified by *InfoBank* as an insolvent company just because we presented our reports according to the *Bapepam* version without being supplemented by the financial report according to the Decree of the Minister of Finance. (My translation.)

The above personal expressions by those who directly deal with the implementation of regulations show that the players in the insurance industry in Indonesia not only struggle to survive in their business but also have been stressed by the confusing regulations. In this regard, the chairman of Internal Audit Unit said on 9 September 2004:

> We have many regulations. Unfortunately, different institutions issue different regulations. If possible, I prefer if regulations are managed under one "umbrella" [one institution]. So, we are not stressed by the confusing regulations because we make different financial reports for different institutions. But...again we have no choice. This is our condition. (My translation.)

The President of the Board of Directors, on 16 September 2004, also expressed a similar concern regarding excessive regulations:

> In regard to compliance with regulations, we sometimes feel tired. There are two different versions of regulations, *Bapepam* versus the Minister of Finance. I think it wastes time and consumes energy. Sometimes when I am doing an analysis I am myself confused about which version of financial reports I am analysing. (My translation.)

Unfortunately, the law enforcement on the regulation is weak. Different institutions have different policies in the enforcement. An ex-external auditor who is currently employed by *Bintang* said on 7 September 2004 that:

> The problem of regulations of financial reporting is in enforcement. The enforcement by *Bapepam* is better than that of the Minister of Finance. For *Bapepam*, if you break the regulation you pay penalties. *Bapepam* is more fair and transparent in enforcing regulations. This body tends to protect the interest of stakeholders and investors. But for the Minister of Finance, the penalties are not clear...what kind of punishment? If you are not able to achieve the targeted risk-based capital (RBC), for example, the institution only ask you to achieve the level of RBC...no penalties. (My translation.)

This statement is also supported by the President of the Board of Directors, who claimed on 16 September 2004 that:

> There are many regulations in the insurance business. We have tried to comply with all regulations. This is our commitment. Sometimes we do not understand the way other market players implement regulations. Why do other insurance companies conduct business without a hundred per cent complying with the regulations? (My translation.)

The above quotations show that there is no different treatment between a company that always complies with regulations and those that do not. To support this claim it will be useful to note what the players in *Bintang* said about regulations. The Director of Administration Service, for example, argued on 8 September 2004 that:

> As far as I know, transparency in financial reporting of the Indonesian insurance business is disappointing. It is true that there are procedures for producing reliable information and we have regulations. It is believed that if we obey regulations we will be recognised as a compliant company. But in reality, procedures and regulations have been used by certain companies as an "umbrella" to conduct unethical business. They claim that they comply with regulations but in practice they break the law. This is usually conducted by private insurance companies. (My translation.)

Another expression can be seen from what the Director of Financial Services said on 24 August 2004 about enforcement and negotiation in the implementation of regulations:

> Enforcement of regulation is very important. I think *Bapepam* is tighter in enforcing regulation than the Ministry of Finance. This might be because *Bapepam* is more concerned with interests of the public. On the contrary the Directorate General of Financial Institutions is like a "friend". In relation to compliance to regulation, insurance companies can make some compromises with the directorate but not with *Bapepam*. (My translation.)

The most interesting statement concerning regulation might be that made by the President of the Board of Directors of *Bintang* on 16 September 2004. She described the problem of regulations as follows:

> This is a matter of my personal opinion. Some representatives of the Indonesian Insurance Board (*Dewan Asuransi Indonesia*) that have a close relationship to the regulators might play a game for their vested interests. They influence the Directorate General of Financial Institutions to issue a certain official letter, which actually benefits them rather than the insurance industry. Another problem is that this institution runs eight different directorates concerning financial institutions. It seems to me that the directorate does not really understand the insurance business. Sometimes the relationship between the issued regulations, the implementation, and enforcement is not clear. What are the consequences for those who do not obey these regulations? It is never clear! (My translation.)

Statements by players in *Bintang* might be too subjective to conclude problems of regulations on the Indonesian insurance business. However, to reach a more objective conclusion, it might be useful to quote statements by those outside *Bintang*. An example of this is a statement by Mr Frans Sahusilawane, the chairman of the Indonesian General Insurance Association. He described the enforcement of regulation on 14 June 2004 as follows:

> The Decree [of the Minister of Finance] Number 481 [/KMK.017/1999] requires insurance business to increase the level of solvency of insurance companies. Companies that are unable to fulfil it [the level of solvency] should merge or consolidate... However, until now [14 June 2004], insolvent insurance companies are still running their business...because the regulator [the DGFI] did not enforce the regulation tightly. (My translation from *Kompas*, a national newspaper)[51] .

Another example concerning a problem with regulations can be seen from a statement by Mr Hotbonar Sinaga, the Chairman of *Dewan Asuransi Indonesia*, the Indonesian Insurance Board, on 21 December 2004. He claimed that:

> To build the public confidence in the insurance industry, the government must enforce the regulations and give a sanction to insurance companies that are unable to meet the level of solvency...The "honeymoon" period between government and the insurance industry has ended. We just need strong law enforcement. If an insurance company is unable to increase its capital and to settle its obligations, the company must stop operating or the government must brings it to the courts to be decided as a bankrupt company. (My translation from *Sinar Harapan*, a national newspaper)[52].

The above statement shows that problems relating to regulations of the insurance industry are mostly with implementation and enforcement. These

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[51] Source: "Restrukturisasi Industry Asuransi Dinilai Berjalan Lambat", *Kompas*, 14 June 2004, Accessible on http://www.kompas.com/kompas-cetak/0406/14/finansial/1080134.htm (accessed 21 January 2005).

[52] Source: "Pertumbuhan Asuransi Umum 2005 Melambat", *Sinar Harapan*, 21 December 2004, Accessible on http://www.sinarharapan.co.id/berita/0412/21/uang01.html (accessed 21 January 2005).

problems are similar to those described by Grabosky and Braithwaite (1986). In the early 1980s, Grabosky and Braithwaite (1986) described Australian regulators as being of "manners gentle", by which they meant that the regulators were slow to use formal enforcement powers. Grabosky and Braithwaite (1986) claimed that this condition is a consequence of regulatory capture. They (1986, p. 203) remarked that:

> …when regulatory agencies have close relations with a small number of regulated companies or regulated industries, they are less punitive, and when regulatory agencies confront big business, they are less punitive.

Apropos to regulations on the Indonesian insurance industry, such disappointing implementation and weak enforcement might not be able to force companies to publish quality financial reports. Consequently, it can be argued that commitment to quality financial reporting and compliance with regulations are determined by companies themselves, especially their ethical culture. Thus, a combination of culture and personal integrity are the foundation of quality financial reporting.

Companies with an ethical culture are more concerned with quality financial reporting practice than those with an unethical culture. As Oliver (2004, p. 31) affirms, to be a truly transparent organisation, it requires "a culture dedicated to openness and a commitment to transparency from an organization's most senior leadership". The ability of a company to internalise an ethical culture will strongly affect organisational players in responding to institutional pressure.

The next section will describe the cultural environment that influences the organisational culture of *Bintang* and shapes the behaviour of its organisational members.

## 7.3 ORGANISATIONAL CULTURE OF *BINTANG*

### 7.3.1 Beliefs and Values in *Bintang*

Chapter Five described the story of *Bintang* in building organisational culture. In general it can be seen from the story that the words *transparency*, *public accountability*, *conservatism* and *ethical business* become discourses in *Bintang*. Those who join *Bintang* will directly experience and are involved in a conversation concerning these words. Any time and any place at which interaction among employees and between employees and top management takes place the words will be mentioned. This can be interpreted that such words are perceived to be taken-fo-granted beliefs and values within this company.

Specific words and their implementation were introduced and internalised by the founders of this company. The founders developed the importance of such words in conducting business, because the establishment of this company was inspired by the Indonesian independence. Consequently, in conducting business, individuals must be publicly accountable and act in accordance with socially imposed values and beliefs to reflect their appreciation of the meaning of independence.

From the founders, the words *transparency*, *public accountability*, *conservatism*, and *ethical business* are internalised in the company through the board of directors, and this board transmits them to the all employees of *Bintang*. The process of internalisation has been achieved through the use of written media, such as desk calendars, employee training and reminder notes on the wall. In addition, through daily behaviour of the board members, the board shows their thought and behaviour as exemplary models to their employees.

Finally, *transparency*, *public accountability*, *conservatism* and *ethical business*, which were initially seen as taken-for-granted beliefs are then used as a basis for codifying the company's code of conduct, called "*Kesepakatan Kerja Bersama*" (Mutual Working Agreement). The implementation of this code is supported by "*Sismajaprima*", an official procedure used to evaluate the competence and performance of employees. Considering the reality of organisational culture in *Bintang*, it can be argued that *Bintang* has developed such culture like a "circuit" as discussed below.

### 7.3.2 Organisational Culture: a Circuit of Ethical Conduct

It is stated in Chapter Five that *Bintang* is a business inspired by the independence of Indonesia. Its business philosophy is then tied to the spirit of the independence and is claimed as an institutionalised belief. The business philosophy of *Bintang,* as advertised in its desk calendar (2004, August sheet), is that in conducting business, *Bintang stands on integrated interests: shareholders, directors and employees, and customers and societies*. In other words, public accountability is seen as the focus of conducting business. In doing so, *Bintang* has developed core values that determine its organisational culture, which is perceived to be in accordance with socially acceptable values.

The core values of the company consist of commitment, positive thinking, credibility, acceptance and carrying out of responsibility, prudence in all business decisions, teamwork, understanding and enjoying business ethics, high customer services and innovations. The employees of *Bintang* believe that the core values of *Bintang* are built based on the internal environment, which refers to the daily behaviours of organisational members since the establishment of the company. These core values are then symbolised in the word "MAJU" (meaning "move forward and become superior"), and they cannot be separated from the principle of accountability. To understand this further, it is helpful to note that by describing corporate values, codes of conduct invite and require an accountability of organisational members to these values (Willmott 1998).

To realise its business philosophy and management of organisational culture, all individuals should act ethically according to the governing regulations and other informal rules. Consequently, the employees of *Bintang* run the insurance business by obeying all rules and regulations and complying with socially imposed norms for maintaining social harmony. The use of annual reports as a rhetorical story for maintenance of social harmony, as discussed in Chapter Six, is an example of such obedience. Commitment to obedience is seen by the staff of *Bintang* as conservatism. This principle has been accepted as a taken-for-granted belief that guides organisational actors in their daily organisational life.

**Figure 7.1 The Circuit of Organisational Culture of *Bintang***

Please see print copy for Figure 7.1

Using the culture paradigm discussed by Schein (2004), the relationship of business philosophy, core values and conservatism can be illustrated as a circuit of organisational culture showing an integrated-ethical value chain that guides organisational actors in conducting business activities (see Figure 7.1). Considering the circuit of organisational culture of *Bintang,* it can be seen that such a culture reflects Javanese culture, the Javanese idea of an ethical social relationship. This is consistent with a claim by Maclagan (1998, p. 145), who supports institutional theory, in that

> ...to survive in the progressively more 'turbulent' social environments, which [are] becoming the norm, organisations would need to adopt and act according to the values that would align them with the expectations of society.

The basic principle of public accountability is identical with the maintenance of social harmony. In this regard, employees of *Bintang* should be publicly accountable and act in accordance with socially imposed values and norms. According to Branscomb (1995), accountability implies acceptance of responsibility, without which there is no basis on which an injured party can initiate a tort action to redress grievances. Furthermore, public accountability can also be seen as a set of social relations. This is because accountability is a socially constructed reality referring to something that is sensible and meaningful.

Referring to Willmott's (1996) work, the construction of such a sensible and meaningful world involves people that lead to the practice of accepted accountability. Moreover, Pollit (2003) and Romzek and Dubnick (1998) argue that public accountability refers to a social relationship in which an actor feels an obligation to explain publicly and justify their conduct to various significant people. These arguments support a claim that public accountability used by *Bintang,* as a business philosophy, reflects the core value of Javanese culture, the maintenance of social harmony.

Conservatism, in the language used by the people of *Bintang*, means total obedience to any governing regulations and compliance with socially imposed values (this will be discussed further in section 7.5.3.2). This view is consistent with Tannsjo (1990, p. 10), who contends that "...conservative attitude is the attitude of one disposed to preserve well-established existing institutions because they exist". By being conservative, *Bintang* wants to respect regulators and any socially acceptable values and avoid a conflict with regulators and the community.

Consequently, it can be inferred that this concept reflects the principles of conflict avoidance and respect.

In line with the social relationship between superiors and subordinates, a "*bapak*" figure and conflict avoidance exist in *Bintang*. For example, the founder, Mr Soedarpo Sastrosatomo, is seen as "a great father" who provides advice and who acts as a problem solver for the company's problems[53]. Convincing evidence concerning a "*Bapak*" figure in *Bintang* can be seen in its website, where the Board of Directors expressed sympathy at the death of a founder.

> On the evening of 19 October 2005, *Pak* (Mr) Idham, a beloved figure, leaves us forever… *Pak* Idham is a figure we love and respect at all times, a figure of *Bapak* (*father*)…a figure who always struggled for the welfare of the Indonesian society…who established this company as a collective environment like a family…He was a leader who was able to show ethical conduct and became an exemplary model for all employees…(My translation.)[54]

In addition, the Board of Directors is seen as a group figures who play a crucial role in the success of *Bintang*. Hence, they should be respected to avoid unnecessary conflict. A statement by the Director of Financial Services on 24 August 2004 concerning a change in the organisational structure illustrates the extent to which conflict avoidance exists in *Bintang*:

> The ideas of changes mostly come from the Board of Directors. But I do not really know how employees respond to the changes. As far as I know they tend to keep silent...no reactions...neither agreement nor disagreement. (My translation.)

This statement can be interpreted as meaning that any changes made in the organisation are intended for maintaining social harmony and therefore it is not

[53] See Chapter Five describing the profiles of the Board of Commissioners.
[54] Source: http://www.asuransibintang.com/index.php, accessed on 18 November 2005

necessary for subordinates to question them. A statement by a subordinate (Mr F) in the Accounting Division expressing his concern regarding a conflict in his workplace confirms this interpretation. He said on 21 September 2004:

> Conflict? ...I think is common in a workplace. I had a conflict with my boss. This conflict came out because of a different point of view. But when a conflict appears I will finish it immediately. I do not want to discuss it further. I mean, I do not want to make the conflict more complicated because I respect him. (My translation.)

The above narrative implies that it is better for subordinates to avoid conflict as such a conflict can lead to disharmony. This evidence is consistent with the study by Hofstede (1982). This description shows that conflict avoidance and respect play important roles in maintaining harmony in the workplace. It is the role of organisational culture to manage such harmony.

In addition, the above narrative signifies that organisational culture is not embedded naturally in an organisation. Instead, it is transmitted deliberately into an organisation. Organisational culture is not a static phenomenon. Schein (1995, pp. 225–226) argues that the basic process of embedding and transmitting a cultural element is a "teaching process" through the use of a number of mechanisms, such as

> …formal statements of organizational philosophy, charters, creeds, material used for recruitments and selection, and socialisation...explicit reward and status system and promotion criteria; stories, legends, myths, and parables about the key people and events...

This means that organisation culture can shape and be shaped by organisational actors. Indeed, organisational culture can influence any organisational activity and practice, including financial reporting practice. For this, Schein (2004, p.1) argues that:

> …culture is both a dynamic phenomenon that surrounds us at all time, being constantly enacted and created by our interactions with others and shaped by leadership behaviour, and a set of structures, routines, rules, and norms that guide and constrain behaviour.

In line with financial reporting practice, it can be argued that as it takes place in an organisational arena, such practice will be strongly influenced by the organisational culture of a company. It is also influenced by interaction between employees of the company and the outside world. Consequently, financial reporting practice is a socially constructed reality involving actors, beliefs, norms and external pressures. Indeed, quality financial reporting practice in *Bintang* is strongly influenced by its ethical culture. The following section will discuss the social construction of financial reporting practice in *Bintang*.

## 7.4 SOCIAL CONSTRUCTION OF FINANCIAL REPORTING PRACTICE

The work of Berger and Luckmann (1984) is useful for understanding financial reporting practice as a socially constructed reality. They (1984) assert that the basic problem in a social construction is how people communicate and cooperate in a complex world, a world that cannot explain itself to individuals. Common knowledge in the form of concepts or "typifications" of both natural and social phenomena, as they (1984) claim, constitutes the basis for creating meanings and orders so that cooperation becomes possible. Thus, they (1984) argue that the world is socially constructed through collective efforts. For Berger and Luckmann (1984), a social reality is constructed through a dialectical process involving three moments "externalisation", "objectivation", and "internalisation".

First of all, in line with "externalisation", Berger and Luckmann (1984) justify the view that an individual's conception of a social reality are given tangible form, externalised in the individual's performance, rituals, symbols and artifacts. In other words, an individual's actions are "externalised" so that they can be observed by the individual and others in the social group. This moment shows a phase in which subjectively constructed "typifications" are expressed.

Second, "objectivation", according to Berger and Luckmann (1984), shows a moment enlightening a process by which the conceptions of a reality are given an objective status in an individual's life. As actions can be scrutinised by others, as they (1984) contend, some will be repeated frequently and are experienced by all individuals in the groups. These actions will eventually become habitualised in the group. In this moment, individuals begin to accept things that they have constructed as an immutable part of their reality. Consequently, this moment shows a step where "typifications" retain an existence that is independent of those creating them and stand out as facts or things (Berger and Luckmann 1984).

The third moment is "internalisation". Berger and Luckmann (1984) point out that this moment shows a process by which the objectivated constructions of past actions are internalised through a socialisation process and become further divorced from the process that creates them. In this phase, these social constructs are taken up and reproduced by others. As Berger and Luckmann (1984) claim, the institutionalisation of such a habitualised routine progresses further if new members join the social group, such as an organisation, and experience a habitualised routine as objective facts performed around the group.

To sum up, social construction of a reality occurs in a condition involving interaction among individuals, and between individuals and the institutional environment. In relation to financial reporting practice, it can be argued that it is an institutionalised practice involving interplay between individuals, organisational culture and the external environment. In the case of *Bintang*, it will be useful to discuss how a response to institutional pressures has become an institutionalised routine and then accepted as a ritual.

### 7.4.1. Financial Reporting Practice in *Bintang* as a Ritual

As discussed in Chapter Three, institutional theory is aimed at explaining how institutional, political and social forces surrounding organisations affect organisational structure and behaviour. As Zucker (1987) claimed, organisations are affected by normative pressures arising from external sources and the organisation itself. Consequently, institutional orders, such as rules and procedures, are frequently used to gain legitimacy and support from society and to claim that organisational actions are in accordance with socially imposed beliefs, norms and values.

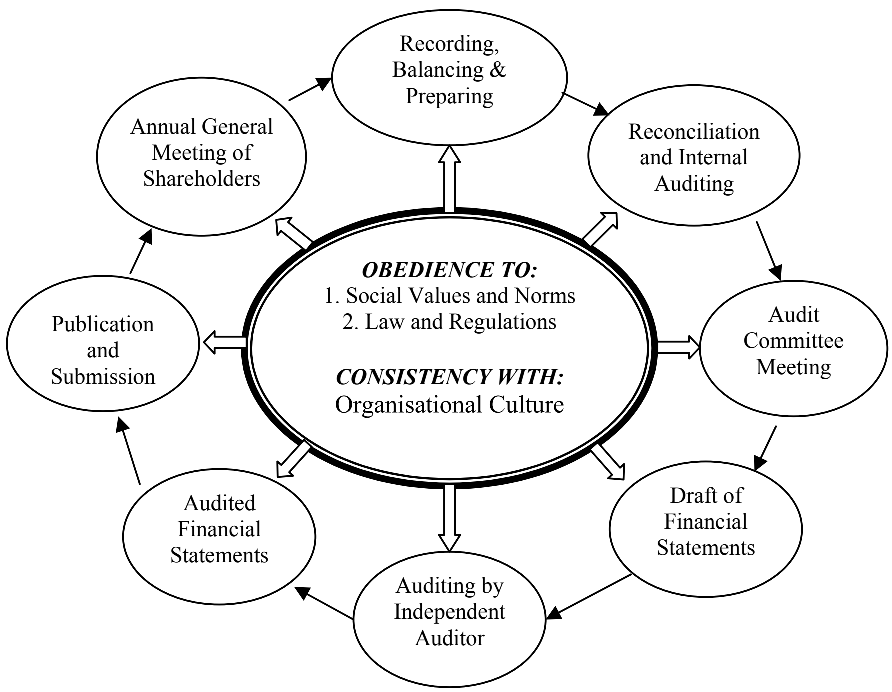
Financial reporting practice, as a part of an organisational reality, can be seen as institutionalised practice. This is because an organisational actor can construct such practice by obeying institutional rules and regulations. This socially constructed practice becomes a routine within the organisation because it is accepted by its members and it is finally embedded in the organisation. To quote Scapen (1994, p. 306), routines are:

> …formalized or institutionalized practice [and] institutions can be seen as imposing form and social coherence upon human activity, partly through the continuing production and reproduction of habits of thought and action.

When such a routine is institutionalised and embedded in the organisation, it becomes a ritual. A ritual denotes a ceremony that is performed in the same way, or something that is performed regularly and in the same way each time (*Oxford English Dictionary*). However, in relation to organisational culture, rituals are routines performed on a regular basis that help to reinforce organisational beliefs and values (Heery and Noon 2001). Based on such an argument, a financial reporting practice is a ritual of constructing and delivering information to an audience. This is consistent with arguments by Burchell et al. (1980) and Miller (1994) who believe that accounting has been institutionalised both on a societal and an organisational level.

In the case of *Bintang*, it can be seen that financial reporting practice is a ritual involving daily activities of identifying, measuring and recording of transactions/events, and finally, communicating information to other parties in a systematic and repeated way. For *Bintang*, the pivot of conducting rituals in regard to the financial reporting process is obedience to social values and norms as well as law and regulations. Moreover, in conducting such rituals, each activity must be consistent with *Bintang*'s organisational culture. Such obedience and consistency are concerned with a particular set of accounting standards and other rules or regulations set by the company or other institutions. Figure 7.2 shows how financial reporting practice is seen as a ritual in *Bintang*.

**Figure 7.2 A Ritual in Financial Reporting Practice**




According to Figure 7.2, a financial reporting practice is associated with the production of periodic financial statements. Within this practice there is a host of working ”ceremonies” involving a number of people and institutions. First, transactions or events are identified, measured and recorded in the journal. All ledgers are then balanced to result in the agreed control accounts. Mr I and Mr K in the Accounting Division described on 22 September 2004 that when financial reports are received from branch offices, accounting staff in the head office, who are responsible for branch accounts, reconcile branch office accounts with the accounts of the head office and ask for approval from the head of the Accounting Division. Next, trial balances are extracted and period-end journals are entered. Finally, staff in the Accounting Division of *Bintang* draw up final accounts.

During these activities, from the identification of transactions to the drawing up of final accounts, the internal auditors of *Bintang* conduct internal auditing processes to ensure that all transactions are measured and recorded in accordance with any rules and regulations and to confirm that an internal control mechanism works well. Any findings regarding non-compliance with regulations and internal control principles are discussed by the head of the Internal Audit Unit with the audit committee along with the Board of Directors. This ritual will produce a draft of financial statements.

As *Bintang* focuses its financial reporting practice on public accountability, the company appoints an independent auditor to ensure that its financial statements are fairly presented in accordance with generally accepted accounting principles and other governing regulations in Indonesia. During the process of auditing, staff in the Accounting Divisions and internal auditors are involved in another ritual with the independent auditor. All stock exchange requirements and requirements by the Minister of Finance are examined and the external auditor must be satisfied of their soundness. Any findings during auditing are discussed and resolved in a meeting involving the external auditor, internal auditors, audit committee and the Board of Directors. This will result in a draft audit opinion. This draft is then discussed by the external auditor with the audit committe and the Board of Directors. After a consensus among staff involved in this discussion is reached the audited financial statements are produced for publication.

All these frantic activities eventually culminate in announcement of annual reports to the stock market (the Jakarta Stock Exchange) and in the presentation of the annual reports to the annual general meeting of shareholders (AGMS). Here, a series of tight reporting deadlines must be met. *Bintang* must submit annual reports to *Bapepam* and the Jakarta Stock Exchange within 120 days of the end of its financial year[55].

The company is also required to submit annual reports to the Department of Trade and Industry within 180 days of the end of its financial year. *Bintang* must also attach a copy of annual reports when it lodges tax returns to the tax office. In addition, *Bintang* must submit their annual reports for the period ended 31 December to the Minister of Finance by 30 April of the following year. Forms and structures of the reports are as determined in the Decision of the DGFI, Number 1298/LK/2000. Most importantly, *Bintang* must publish financial statements in two national newspapers. Thus, timeliness is of the essence.

In line with the AGMS, *Bintang* has allocated significant resources to the meeting. The AGMS is used as an arena for discussing historical performance, the company's future, management capabilities and approval of financial statements by shareholders. The AGMS can be seen as a conventional formality. During this meeting, little real business might be conducted or decisions that have not already

[55] In 2002, through the *Bapepam* Regulation No. X.K.2 *Obligation to Submit Annual Reports,* the period of submission is shortened to 90 days after the end of company's financial year.

been discussed and settled might be taken. This meeting usually takes place in July after the end of the company fiscal year. Activities in the AGMS will eventually create other transactions that are required to be identified, measured and recorded as the first step of financial reporting practice.

Within financial reporting practice, there is a repetition of working activities strongly associated with traditions and rituals. Such rituals involve actors, time and place, repeated actions, and “a holy guidance of ceremony” (regulations, law, standards and procedures). In addition, it is interesting to consider that the ritual in financial reporting practice involves a physical meeting at a given place and time, despite the increased globalisation of corporations and electronic communications of the current era.

The description of financial reporting practice of *Bintang* shows that financial reporting is an institutionalised practice that is socially constructed and eventually becomes a ritual in the company. In this regard, most of the employees in *Bintang* dealing with the preparation and publication of annual reports see their jobs as routines and part of their rituals. For example, the head of the Internal Audit Unit of *Bintang* claimed on 9 September 2004 that:

> Financial reporting is a routine activity. However, it should be noted that a financial report is not only concerned with historical events, but also concerned with the future. In the new regulations, *Bapepam* insists that if an insurance company is unable to achieve targeted results, the company must publish a special report to accompany the audited financial report. This becomes our routine. (My translation.)

Another employee in the Accounting Division of *Bintang* (Mr C) confirmed on 7 September 2004 that:

> My job is to ensure that all transactions are presented according to Indonesian accounting standards and financial reports comply with regulations issued by *Bapepam* and the Minister of Finance. I also provide back-up for urgent information required by the Board of Directors. (My translation.)

These statements imply that financial reporting practice is a ritual, and most of the activities in such a ritual concern compliance to any socially imposed beliefs and norms, as well as adherence to the governing regulations. Such a ritual has been employed by *Bintang*'s actors to construct financial reporting as a rhetorical story for social harmony as discussed in Chapter Six.

What has been practised in *Bintang* is consistent with the claims that accounting procedures that are viewed as rational and efficient by society have been used as a medium to legitimate organisational operations and to secure their survival (Ansari and Euske 1987; Burchell, et al. 1980; Carruthers 1995; Covaleski, et al. 1996; Markus and Pfeffer 1983; Miller 1994). In addition, to anticipate uncertainties, organisations can adopt certain financial reporting practices by imitating those practised by other companies or implementing procedures and regulations issued by authoritative bodies and professions. This view indicates that financial reporting practice, as a part of an accounting system, is symbolic and ritualistic (March and Olsen 1989; Meyer and Scott 1983). What can be inferred here is that in the existing environment, financial statements as products of an accounting system can shape and be shaped by organisational actors and other institutions within which the company's activities take place (Mouritsen 1994).

The professionals and authoritative bodies that construct the institutional environment such as faiths, rules and institutionalised roles (Meyer and Rowan 1977) can be seen as sources of complicated rules and frameworks of institutionalised behaviour. Within institutional theory, these rules and frameworks are perceived as rationalised myths, and are utilised as a means of legitimisation. Consequently, financial reporting practice is viewed as a device of legitimisation within the social environment. As such, through the process of isomorphism, actors can construct financial reporting practice to produce a rhetorical story of a company's activity for the purposes of gaining legitimacy and maintaining social harmony. How *Bintang* responds to institutional pressures can be seen in the following section.

#### 7.4.2 Institutional Isomorphism in Financial Reporting: a *Bintang* Story

Institutional theory explains that organisational structures and procedures are shaped by the social environment. Organisations, as Meyer and Rowan (1977) suggest, tend to be homogenous in their practice through a process of isomorphism to reflect rationalised rules. In line with financial reporting practice, because of the environmental pressures, commitment of an organisation to quality financial reporting practice could be a result of isomorphism.

##### 7.4.2.1 Coercive Isomorphism

Coercive isomorphism refers to pressures to obey rules and regulations issued by authoritative bodies or organisations. These pressures are characterised by means of authority and coercive power. Regulations issued by *Bapepam* and the Minister of Finance are examples of pressures in financial reporting practice in Indonesia. Thus, as Fliegstein (1990) maintains, the influence of the authoritative bodies, such as government agencies, by means of rules for companies, need not be demonstrated any more.

It can be seen that *Bintang* is responsive to the institutional pressures that come from regulations. Indeed, an employee in the Accounting Division (Mr A) clarified on 3 September 2004 that:

> …changes in accounting policies are usually caused by new regulations. (My translation.)

Moreover, an ex-external auditor who is currently employed by *Bintang* (Mr C) asserted on 7 September 2004 that

> ...financial statements must be...fairly presented in accordance with accounting standards and any regulations...It is the regulations that determine the statements. (My translation.)

This statement indicates that *Bintang* has actively responded to financial reporting changes if a regulator issued new rules, procedures or regulations. Compliance to all governing regulations has been seen as a part of *Bintang*'s corporate culture. In regard to this, Mr F in the Accounting Division expressed his pride in *Bintang*. He said on 21 September 2003:

> If I compare to the company I worked before, annual reports of *Bintang* are the best. I mean, *Bintang* always complies with regulations. If new regulations are issued, *Bintang* will directly implement the regulations. For me, a quality financial report is a report that is presented according to regulations...Thus, we must obey the regulations when preparing financial reports even though the bottom line is minus [loss]. During my time here, I never hear that *Bintang* disobeys regulations. (My translation.)

This statement can be interpreted as meaning that obedience to regulations is a non-negotiable culture in *Bintang*. All employees must either take it or leave it. Another statement also confirms such interpretation. Mr E, in the Accounting Division, who has worked at *Bintang* more than 25 years, claimed on 21 September 2004:

> The reason why this company has been awarded the annual report award is that we always obey all regulations. We always do what the regulations ask us to do. (My translation.)

In regard to the reason why *Bintang* enjoys complying with regulations, it is interesting to consider a statement by the head of a branch office (Mr H) whose office is located far from the head office. On 5 October 2004, he highlighted:

> The reason why *Bintang* obeys the regulations is that compliance with regulations makes us so comfortable in conducting business and makes us feel free in conducting business. We can also reduce the negative impact of conducting business by obeying regulations. (My translation.)

The words “comfortable”, and “negative impact” can be interpreted as meaning that *Bintang* has directed its organisational culture to the maintenance of social harmony.

Users, such as shareholders and financial analysts, although they are not directly involved in daily organisational activities, have been suspected of playing a role in shaping financial reporting practice. This is because they have interests in the numbers contained, and information disclosed, in annual reports. This argument can be seen from the story of *Bintang* when it published financial statements (the *Bapepam* version) in a national newspaper without being supplemented with a report according to the version of the Minister of Finance.

Soon after the publication, financial analysts in the *InfoBank* magazine No. 304 July 2004, classified *Bintang* as an insolvent company and placed the company under pressure. In response to this pressure, the Board of Directors sent a letter (No. 173/SK/Pres.Dir/AS/VII/2004 dated 9 July 2004) to the publisher of the magazine, claiming that such a classification was not true. The letter also explained the differences in financial ratios calculated under the two different versions of financial statements and showed that *Bintang* was not insolvent.

Financial reporting practice in *Bintang* is consistent with a claim that environmental pressures from investors tend to increase when they are reinforced by the demands of information made by financial analysts. According to Williams (1996), this is because the decisions on investment are, to some extent, made on the basis of the financial analysts' forecasts.

**7.4.2.2 Mimetic Isomorphism**

Mimetic isomorphism occurs when an organisation is facing a high level of uncertainty. Accordingly, uncertainty about organisational technologies, goals and environmental expectations often force organisations to imitate other organisations.

In order to support a commitment to quality financial reporting practice, it is not hard for *Bintang* to copy the ethical practice of financial reporting of other companies.  This can be seen from statements by organisational members of *Bintang*. For example, Mr C in the Accounting Division understands how *Bintang* is flexible in imitating practice by other companies. He claimed on 7 September 2004:

> I think *Bintang* is very flexible in responding to environmental changes. It is not difficult for *Bintang* to adopt ethical business practices conducted by other companies. This is very good, especially for the implementation of good corporate governance. *Bintang* also responds quickly to new regulations or methods issued by authoritative bodies. (My translation.)

Similarly, the Director of Administration Services highlighted on 8 September 2004 that:

> …to imitate what other companies have practised is not a problem for *Bintang*. Indeed we can copy their practices as long as such practices are concerned with an ethical business. This is because we want to make this company better and more ethical in the way it does business. (My translation.)

The Director of Financial Services also identified the importance of copying ethical practice in financial reporting for the purpose of increasing the quality of transparency in Indonesia, even though such practices come from other countries. On 24 August 2004, he affirmed:

> We know that the demand for transparency of the Indonesia business is very high. The current news in *Business Indonesia* [a national newspaper] showed that transparency of Indonesian companies was the lowest among other countries. So, if one day I might want to apply the requirements stated in the Sarbanes Oxley Act to my company's annual reports, even though it is an American rule and it might be difficult to apply. (My translation.)

A number of media can be referenced by *Bintang*'s staff if they want to better understand the financial reporting practices of other companies. These include workshops and stories by members of the audit committee. In this regard, it is useful to consider a statement by Mr A, who has worked at *Bintang* for more than 25 years. He said on 3 September 2004 that:

> …copying procedures or practices of financial reporting by other companies is not a problem for *Bintang* as long as such adoption is intended for more ethical purposes. An opportunity to attend seminars or workshops is a medium for understanding what other companies do. (My translation.)

In addition, the head of Internal Audit Unit agreed with the adoption of financial reporting practices conducted by other companies. He said on 9 September 2004:

> I think *Bintang* does not mind adopting other company practices. The Audit Committee, for example, consists of members from other institutions with an accounting background. They provide me with a number of good practices as a benchmark....In certain cases, they provide some solutions by referring to practices of other successful companies, including practices of transparency. (My translation.)

How *Bintang* has copied other companies' practices is consistent with claims in the accounting literature. For example, a study by Neu (1992) indicated that financial reporting in an industry was seen as an influence of mimetic order. Neu's (1992) work confirmed that one company published more frequent forecasts of profits because other companies in the same industry (the mining sector and the financial institutions sector) published similar forecasts. Another example of mimetic isomorphism in financial reporting is the tendency of a company to imitate another company's financial disclosure by disclosing social and environmental information in financial reports (Deegan and Gordon 1996; Patten 1992). The tendency to imitate the practice of other companies is mostly conducted to gain legitimacy.

#### 7.4.2.3 Normative Isomorphism

Institutional analysis also encompasses the role of professions and professionalisation (Meyer and Scott 1983; DiMaggio and Powell 1983). Within business activities, professionals prescribe practices, and these are adopted because they are prescribed.

In relation to normative isomorphism, to some extent, *Bintang* has also relied on financial reporting practice prescribed by professions. Indeed, *Bintang* has appointed two foreign consultants especially to develop information technology to support a reporting mechanism. In this regard, the Director of Administration Services clarified on 8 September 2004 that:

> Most activities in this company have been supported by professional consultants...We have also employed two foreign consultants. The reason for hiring the foreign consultants is their experience in the insurance business and information technology. It is difficult to find an Indonesian consultant who understands both the insurance business and information technology. Thus, experience and skills in the insurance business and information technology are the main reasons for hiring foreign consultants. (My translation.)

Another profession that is seen as a key critical factor in influencing quality financial reporting is external auditing. On 3 September 2004, an employee in the Accounting Division (Mr A) explained that

> The financial statements of *Bintang* are complete and reliable...because such statements have been audited by an independent auditor with a good reputation. So, for me, this auditor is the determinant of quality financial reports. And I believe that what has been done by the auditors to make financial statements in accordance with requirements by regulations are the way we can use to assess the quality of financial reports. (My translation.)

The Director of Administration Services also confirmed the importance of external auditors in ensuring quality financial reporting practice. He said on 8 September 2004:

> I think collusion between the external auditor and the client might occur. It is not easy to avoid this possible collusion. This has occurred in our society. To avoid such collusion, *Bintang* always appoints the big five firms. We believe that the big five are more credible than other audit firms. The big five firms are more accountable and I believe that...the external auditor provides a significant contribution to the quality of financial reports...It is the role of the auditor to judge whether we comply with rules and regulations. (My translation.)

Normative isomorphism in *Bintang* is consistent with a claim by DiMaggio and Powell (1983) who point out that normative isomorphism arising from strong professional norms in an organisational field will create a tendency for organisations to resemble one another in their structure and process. These norms are transmitted to organisational practices by the process of authorisation (Scott 1995). Thomas (1989) also claims that to cope with environmental changes and uncertainties, a company will rely on professional specialists, such as accountants and auditors, who will exert their influence on corporate strategy, including disclosure decisions.

Statements by the staff of *Bintang*, and how the company reacts to external pressures exhibit that there is an interaction between these individuals with the external environment in constructing financial reporting practice. The way that employees obey regulations and socially imposed values, and imitate practices by other companies, and also appoint professional specialists, show that financial reporting practice is a socially constructed reality. This is what Munro

(1998, pp. 201–202) claims that "accounting numbers do not simply appear by virtue of their collection and collation; they are *socially constructed*...[and are] *invested* with values" [original emphasis].

However, it is important to note that in the case of *Bintang*, organisational culture might be the most influential factor in shaping individual actions in *Bintang* concerning financial reporting practice. The following sections will discuss how organisational culture influences financial reporting practice in *Bintang*.

### 7.4.3 Organisational Culture and Financial Reporting Practice

It was shown in Chapter Five that financial reporting practice of *Bintang* is strongly influenced by its organisational culture. Public accountability, conservatism, transparency and ethical conduct have been taken for granted as the cornerstones for producing and publishing reliable information through financial reporting. These beliefs are perceived as characteristic of *Bintang*'s culture. In fact, the organisational culture of *Bintang* has shaped its employees in constructing quality financial reporting practice. In this regard, the former Chairman of the Audit Committee, who is also a minority shareholder, claimed on 8 September 2004 that:

> Before joining *Bintang*, a famous television company in Indonesia offered me a job as a director. But I prefer working in *Bintang*, as I have never seen a company with an ethical and holy vision like *Bintang*. I told my friend, I am very satisfied working here because for me working is part of my worship and *Bintang* provides me the opportunity to practise ethical conduct. (My translation.)

This statement is supported by the Director of Financial Services on 24 August 2004:

> I know that *Pak* Andy holds double roles as a director and shareholder. However, I never find any conflicts of interest regarding the roles. It is our moral responsibility to avoid conflict of interests. This is another reason why I enjoy working here. We are never involved in any conflicts of interest. If we talk about money, I believe Pak Andy will choose a job as a director of a prestigious TV company, as he was offered the job before joining *Bintang*. (My translation.)

This statement implies that organisational culture of *Bintang* has shaped the behaviour of its employees and makes them comfortable working there. This reflects what Hofstede (1997) suggested, that culture could play a role as a control mechanism on managers' behaviour.

The head of the Internal Audit Unit has an interesting view concerning the relationship between organisational culture and financial reporting practice. On 9 September 2004 he justified his statements as follows:

> We have no crucial changes in financial reports. The insurance industry has standardised financial statements. We always obey regulations. But it should be noted that regulations are only a guide. We have no choice except to comply with the regulations. You should know that the format of financial statements is the same as another insurance company. What makes it different is the output of financial reporting practice. Output needs process and process is greatly influenced by the corporate culture. We always attach a voluntary explanation of any items that we consider important for users to know. This is part of our commitment to transparent reporting. We always try to disclose any information as transparently as possible. (My translation.)

His subordinates also supported the statement. For example Mr B said on 14 September 2004 that:

> *Bintang* has produced transparent financial reports. It is very transparent indeed. This happens because of our culture. (My translation.)

An example of the influence of organisational culture on financial reporting practice can also be seen from the statement by the Director of Financial Services on 24 August 2004:

> We made a significant change in the current annual report [2002]. We changed the way we calculated the unearned premium account. There is a regulation determining how to calculate this account, but we are used to calculating the account more conservatively. It is more prudent if we talk about the insurance business. The point is that we include commission as a deduction of unearned premium. I apply a conservative approach for maintaining the company's solvency. (My translation.)

Financial reporting practice in *Bintang* shows that there is a strong relationship between organisational culture and quality financial reporting. This implies that a company with an ethical culture will more likely be committed to quality financial reporting practice than companies with unethical cultures. This is consistent with claims of such relationships in the accounting literature (Adams and Kuasirikun 2000; Geriesh 2003; Lewis and Unerman 1999).

Studies of fraudulent financial reporting practice also demonstrated that financial reporting fraud is influenced by a set of ethical values reflected by dishonest management, personality anomalies, lies and crookedness (Loebbecke, et al. (1989), and a poor organisational culture (Merchant 1987). A poor organisational culture, according to Merchant (1987), is a culture typified by a lack of moral principles, guidance and leadership; as well as no internal rules, policies and procedures. Adams (2002) remarks that culture reflects moral values, which one would expect in turn to influence at least the issues on which companies perceive as worthy of annual reports.

The story of *Bintang* provides a real and interesting portrait of a relationship between an organisational culture and financial reporting practice. Different from financial reporting practices of other companies, the financial reporting practice in *Bintang* reflects a local culture—Javanese culture—that shapes not only individual behaviour but also its organisational culture. The following section will discuss an example of how the financial reporting practice of *Bintang* reflects Javanese culture.

**7.4.3.1 Financial Reporting Practice: a Reflection of Javanese Values**

As discussed in Chapter Six, the financial reporting practice of *Bintang* is constructed as a rhetorical story to gain legitimacy and maintain social harmony. The reason that the company conducts such practices in this way is because it reflects Javanese culture. It was discussed in the previous section that to maintain social harmony, individuals should be members of a group and should work within the framework of *gotong royong* and *musyawarah.* These Javanese values can also be seen in *Bintang*.

The organisational reality of *Bintang* indicates that success is a collective achievement under the guidance of its management. In line with the concept *gotong royong* (cooperation), the establishment of executive committees in *Bintang* can be seen as an example of cooperation. Even though such committees are not mainly found in the Accounting Division, several employees in the Accounting Division are also members of the committees. Consequently, the committees play (consciously or unconsciously) roles in constructing financial reporting practice. For example the Director of Financial Services said on 24 August 2004 that:

> ...the committees are actually intended to build better control. However, since the establishment of committees has been part of a trend in implementing the practice of good corporate governance, we decided to make some executive committees. On these committees we decide *everything together*. (My translation; emphasis added.)

Similarly, the Director of Administration Services on 8 September 2004 pointed out that:

> ...we...establish and utilise committees for the purpose of showing that we make a collective decision. Directors do not make their own decisions. We try to develop *collectivism*. (My translation; emphasis added.)

This view is also consistent with that of the manager, who is responsible for underwriting policies. He said on 15 September 2004:

> The executive committee is intended to ensure that crucial decisions are not determined by a single person. The use of a team in the decision-making process will lead to a better decision. As far as I know the committees have run well and *togetherness* in teamwork is part of our culture. (My translation; emphasis added.)

In addition, in the 2001 annual report of *Bintang*, the Chairman of the Board of Commissioners expressed his feelings in regard to the importance of helping each other (*gotong royong*). He said (p. 15):

> Finally, we also extend our deep appreciation to shareholders, all employees of *PT. Asuransi Bintang, Tbk* agents and business partners, and all financial authorities that have contributed to the success of *PT. Asuransi Bintang, Tbk* and we hope that this cooperation can be further extended in the forthcoming years. (My translation.)

Moreover, an example of *musyawarah* can be seen from a discussion held by the Audit Committee of *Bintang* regarding changes in the calculation of the estimated unearned premium. On 24 March 2003 the Audit Committee and the Board of Directors held a meeting with an external auditor to discuss the final draft of the annual report. In this meeting they discussed issues concerning compliance with regulations, a proposal for improving an internal control system, an audit report draft, and accounting policies and disclosures in the 2002 annual report.

A long discussion concerned an accounting treatment and necessary disclosure in regard to changes in the calculation of the estimated unearned premium. The external auditor believed that changes in the calculation of the unearned premium should be classified as a change in estimation, rather than a change in an accounting method.

According to the Director of Financial Services, a change in the calculation that made the estimated unearned premium was Rp. 12 billion lower than that of the previous calculation, which was intended to fulfil the requirement of Decree of the Minister of Finance No. 481/KMK017/1999[56], and was not intended to increase the company profit. Such a change is not against the law. Indeed, the President of the Board of Directors argued that such a change is allowed by the authoritative body and said:

> I personally discussed this issue [changes in the calculation of the estimated unearned premium] with the regulator [the Department of Finance] and also wrote a letter to the regulator. It is not a problem. We still use 40 per cent in the calculation. The difference is only in the basis of calculation. Previously we calculated 40 per cent of the net premium and now we calculate 40 per cent of the net premium after a deduction of a net commission. (My translation.)

[56] This decree is replaced by the Decree Number 424/KMK.06/2003, which requests insurance companies to achieve the level of solvency at 75 per cent, 100 per cent, 120 per cent by the end of 2002, 2003 and 2004 respectively.

Furthermore, in the meeting, one of audit committee members asked a question of the external auditor regarding the changes. She said:

> What do you think about this change? Is this an estimation change or a change in an accounting method? If this change is concerned with an accounting change, there should be disclosure of why the auditor agrees with the change. Restatement on the 2001 financial statements should also be done for the change. (My translation.)

In reply to the question the external auditor argued that:

> This is an estimation change because there are only two calculation methods of the estimated unearned premium: the aggregate method and the daily basis method. The change is only concerned with the basis of calculation. We have internally discussed this change with other auditors. I believe that the change is more related to an estimation change, rather than a change in accounting method. (My translation.)

After discussing this change, a compromise was finally made and the Chairman of the Audit Committee suggested that the auditor should clearly express such a change in the 2002 annual report that it is legally allowed and still complies with regulations, especially the decree of the Minister of Finance No. 481/KMK.017/1999. As a result of the discussion, the external auditor disclosed the changes in the notes to the 2002 financial statement (note 2h) as follows:

> In 2001, the estimated unearned premium is computed based on the aggregate percentage method at the rate of 40 per cent of the net premium. Effective from 2002, the company adopts the aggregate percentage method of 40 per cent of the net premium after a deduction of a net commission. The change in the computation still meets the Decree of the Ministry of Finance No. 481/KMK.017/1999 dated 7 October 1999 and the Letter of the Insurance Director, the Directorate General of Finance Institutions, Number S4212/LK/2000 dated 23 August 2000. If the 2002 estimated unearned premium is computed based on the aggregate percentage method of the net premium without a deduction of net commission, the unearned premium will increase by Rp 12,403,893,000. The change in the estimated unearned premiums computation was made in order for the company to still comply with the ratio of investment to technical reserve and claim payable as required by the Decree of the Ministry of Finance.

This example shows how *musyawarah* guides individuals in *Bintang* to make a collective decision. The importance of *musyawarah* is also supported by the Director of Financial Services, who argued on 24 August 2004 that:

> ...before a final draft of financial statements is signed, the external auditor reviews the draft and sometimes we have a conflict with the auditor, for example, about the use of a certain terminology of information being disclosed in annual reports. We usually overcome this conflict by making a *compromise*. (My translation; emphasis added.)

The above narratives illustrated how *gotong royong* and *musyawarah* influence financial reporting practice in *Bintang*. Clearly, maintaining social harmony is the ultimate purpose of publishing quality annual reports. This supports the view expressed by Maclagan (1998, p. 141) that "...organizations are seen as adapting to a set of norms in the social environment, and gaining legitimacy".

#### 7.4.3.2 Conservatism: a Lesson From *Bintang*

In accounting literature, conservatism is concerned with procedures adopted by an accountant when facing uncertainties. It is unquestionable that conservatism holds an extremely important place in the ethos of accounting (Wolk, et al. 2001). Conservatism guides accountants to make decisions based on logic and evidence that will lead to the fairest presentation of financial statements. According to conservatism, when accountants are facing uncertainty as to which accounting procedures or methods to apply, they tend to choose the procedures that will be least likely to overstate assets or income.

However, within *Bintang*'s context, the word conservatism has a broader meaning than that generally accepted in accounting literature. In *Bintang*, conservatism is applied not only in financial reporting practice, but also in all aspects of organisational life. This argument is based on the fact that for *Bintang*, conservatism is more than just choosing a procedure. Rather, it conveys an ideology, values and beliefs. Consequently, *Bintang* views conservatism in the same way as is commonly used in politics.

In politics, conservatism might be seen as a philosophy or ideology supporting the importance of traditional values or established social order. Thus to quote Tannsjo (1990, p. 4):

> …the conservative attitude...is characterized by two central tenets...(1) that whatever exists as a well established fact ought to continue to exist and (2) that the reason why it ought to continue to exist is that it is well established.

It should be noted that for proponents of conservatism, tradition does not merely mean customs or habits, but consists of standards and institutions that are perceived to be a guide to promote a well-ordered life (Jost, et al. 2003; Kirk 2001). Therefore, the orientation of a conservative attitude is to maintain order and stability and to adhere to pre-existing social norms.

In light of conservatism, orientation to values plays an important role in shaping the behaviour of employees. In this regard, a conservative attitude derives values from traditions and judges the world around the individuals to be organised by the standards they trust (Jost, et al. 2003). In addition, they do not simply preserve traditional or established values, but ensure that a society is socially ordered according to its values (Muller 2001; Stone 1994).

To keep tradition alive, for example, in an organisational context, conservatives pass it down from generation to generation, from superiors to subordinates, who embody the conservative attitude of the organisation. In other words, to maintain a conservative attitude a leader must be able to institutionalise the attitude in an organisation's life. The following section describes how conservatism is embedded in financial reporting practice in *Bintang*.

#### 7.4.3.2.1 Conservatism in *Bintang*: a Reflection of Javanese Culture

The concept of conservatism applied in *Bintang* is similar to that used in politics. Thus, for *Bintang* to be conservative, its staff must be able to conduct ethical business and obey regulations and any socially acceptable norms and values for the purpose of maintaining stability and order in Indonesian society. *Bintang* has employed conservatism since the establishment of the company. The reason for this is that *Bintang* was established not simply to raise profits, but to improve the welfare of Indonesian society. This can be seen from a statement by the charismatic founder, Mr Soedarpo Sastrosatomo in the 2004 Management Annual Meeting of *Bintang* on 4 February 2004. He said:

> *Bintang* not only raises money, but also utilises our independence so that we can fight in our own country. We have a holy spirit. The founders then have institutionalised the holy spirit in *Bintang*, to enable its organisational members to utilise our independence and to improve the prosperity of our society. (My translation.)

This statement implies that the improvement of social wealth is more important than profit maximisation. Thus, conducting ethical business is the only way to achieve such an objective. In so doing, *Bintang* always obeys all regulations and operates in accordance with socially acceptable values. This has been accepted as a tradition of *Bintang* in dealing with insurance business and external pressures.

Conservative attitude in *Bintang* is also confirmed by Mr A in the Accounting Division, who said on 3 September 2004:

> From its establishment *Bintang* always complies with all regulations promulgated by authorised bodies. This is why *Bintang* is well known as a conservative company. This is part of our culture... (My translation.)

This statement is supported by Mr G, the manager who is responsible for underwriting policies. He maintained that *Bintang* is committed to obeying regulations. He said on 15 September 2004 that:

> *Bintang* is very conservative in implementing regulations. *Bintang* has continuously kept obeying any regulations. (My translation.)

Such statements indicate that in *Bintang*, as discussed before, the conservative attitude has been accepted as a taken-for-granted belief that guides its employees in conducting business. A statement by Mr B, a senior internal auditor, on 14 September illustrates this view:

> As far as I know, *Bintang* is conservative in conducting business. With or without formal rules we tend to conduct ourselves ethically...I think since the establishment of *Bintang*, we have run the business conservatively. The founders of this company always remind us about the importance of being honest, ethical and fair in doing business. I am proud of working here. Even though *Bintang* is a small company, it always runs an ethical business. (My translation.)

In addition, being conservative does not mean static. Instead, such an attitude has driven *Bintang* to be responsive to external pressures. An active response to new regulations is an example of *Bintang*'s flexibility, even though the Indonesian business environment has been surrounded by unethical business and corrupt government. In this regard, it is interesting to note what employees of *Bintang* said about conservatism and external pressures. For example, on 5 October 2004, Mr H believed that:

> Although *Bintang* is conservative, this company is very flexible in responding to changes in the business environment...Management always complies with regulations. If a new regulation is issued, *Bintang* usually establishes a team to discuss whether the regulation only affects the head office or influences both the head office and branch offices. Thus, we can anticipate the consequences of any regulations. (My translation.)

This statement is supported by Mr B, who contended on 14 September 2004 that:

> We are very flexible in responding to environmental changes...Thus, being conservative does not mean we neglect the changes in the business environment. We also adopt new concepts introduced by professional accounting bodies, as long as the concepts are consistent with our culture. (My translation.)

Another claim showing the commitment of *Bintang* to be conservative can be seen from a statement by the Director of Administration Services. He said on 8 September 2004:

> In line with the flexibility of *Bintang* to respond to environmental changes, I think *Bintang* employs a conservative approach. This is a positive policy because currently we have tight regulations. However, these tight regulations are not a major problem for *Bintang*, as the conservative approach has led *Bintang* to keep obeying the regulations. It is true that the tight regulations have made insurance business more difficult. But for *Bintang*, because of the conservative approach, to implement the tight regulations is not as difficult as for other insurance companies. Indeed, many insurance companies collapsed because of the regulations. Thus, I believe that conservatism is good for supporting the implementation of regulations...However, as *Bintang* is used to obeying the rules and never conducts unethical business activities, sometimes the conservative

> approach makes it difficult for *Bintang* to compete with other insurance companies. We know that we might be able to conduct business like other companies, such as illegally reducing the customer's premiums, which result in getting costumers. But we do not want to do that... (My translation.)

Such quotations showed that "the organization and the management of work involve moral matters and ethical dilemmas from top to bottom from beginning to end" (Watson 1998, p. 253). The reason that organisational members of *Bintang* conduct ethical business can be related to a view by Blanchard and Peale (1988, p. 7) who wrote that:

> …ethical behaviour is related to self-esteem...that people who feel good about themselves have what it takes to withstand outside pressures and to do what is right rather than do what is merely expedient, popular, or lucrative... that a strong code of morality in any business is the first step toward its success...that ethical managers are winning managers.

What has been practised in *Bintang* also illustrates that the company has tried to judge the business environment to be well ordered by the values that *Bintang* trusts, as Jost, et al. (2003) describe. This implies that *Bintang* obeys regulations to ensure that there is social order and stability of society according to its values. This view is actually a reflection of Javanese culture. Indeed, for *Bintang*, maintenance of social harmony is the most important thing in conducting business, including financial reporting practice. To achieve this *Bintang* has implemented the philosophy "s*epi ing pamrih, rame ing gawe, mangayu ayuning bawana"* —be disinterested, work hard, perfect the world (Antlov 1994, p. 77).

Obedience to regulations shows that *Bintang* wants to avoid unnecessary conflicts and respect those who issue the regulations. To quote Jost, et al. (2003, p.340), "conservative ideologies—like virtually all other belief systems—are adopted in part because they satisfy some psychological needs". Moreover, the case of *Bintang* shows that:

> ...*accounting* is intimately implicated in the construction of facilitation of the contexts in which it operates. It cannot be extracted from its environment like an individual organism from its habitat...Accounting as a social institution is shaped by culture to present and explain certain phenomena concerning economic transactions. As a social institution, accounting is integrated into customs, values, norms, beliefs accepted in a society. Thus accounting cannot be isolated and analysed as practice that is free from culture. The existence of accounting is determined by culture, customs, norms, and institutions (Hopwood, et al. 1994, p. 228; original emphasis).

Based on such reasons, the case of *Bintang* also signifies that its organisational actors have constructed the company as a part of a wider social community. Thus, "individuals in both an organisation and a society should behave so at to achieve forms of self-actualisation that leads to social harmony" (Legge 1998, p. 159).

As previously claimed, to keep tradition alive, a conservative attitude must be transfered from those in top positions to subordinates to make such an attitude internalised in the company. The following section will discuss how the institutionalisation of concervatism occurs in *Bintang*.

#### 7.4.3.2.2 Conservatism: Institutionalisation by a "*Bapak*"-Father Figure

As previously mentioned, Berger and Luckmann (1984) argue that social reality is constructed through a dialectical process involving three moments: "externalisation", "objectivation" and "internalisation". In line with how a conservative attitude is embedded in *Bintang*, the figure of *Bapak*-father is perceived to be the actor who has institutionalised such an attitude. This was initially internalised by the founders and has been further institutionalised in *Bintang* by those who are in top management positions. Denison, et al. (2004, p. 64) claim that "the role of the founder is crucial to establishing an organisation's identity, core belief, and purpose".

Besides the fact that institutionalisation of such an attitude is performed through a number of communication media, the institutionalisation of conservatism in *Bintang* is conducted through the daily behaviour of *Bintang*'s leaders. This is consistent with views by Hunt and Laing (1997) and Schein (1996) that effective leaders use a variety of behaviours, oral and written communications to transmit their visions, differences, values and beliefs to their subordinates. In so doing, the leaders of *Bintang* have been able to develop themselves by altering their attitudes and behaviour in the organisation's life to become exemplary models for their subordinates.

To further analyse how the institutionalisation of the conservative attitude has occurred in *Bintang*, it is useful to understand what the employees have said about this process. For example, Mr B in the Internal Audit Unit said on 14 September 2004:

> This company has been managed using different styles and there is no gender bias. But, I think...the culture and philosophy of *Bintang* are still the same. This is because the Board of Commissioners, who are also the founders, always ... remind us of the importance of being conservative in business...the importance of being honest, ethical, and fair in conducting business. (My translation.)

Similarly, the Director of Financial Services argued on 24 August 2004 that

> ...*Bintang* has been directed to do clean and ethical business. So, we have tried to conduct a clean business in all aspects of the business. Even though it is very difficult to do that, and we know our business environment is dirty, I see that there is a spirit in this company to do so. This spirit has been institutionalised by the founders. (My translation.)

Another employee in the Accounting Division, Mr A, also expressed his concerns regarding how such institutionalisation has occurred in *Bintang*. He said on 3 September 2004 that:

> This [conservative attitude] is part of our culture institutionalised by the founders such as *Pak* Darpo [Mr. Soedarpo] and *Pak* Idham. This tradition [conservatism] is a commitment that is strongly maintained by the founders and there is no space for us to break the tradition. It is a very strong belief. We have no power to change the tradition...I believe that all employees understand the value [conservatism] and have implemented it. Otherwise, he/she will certainly leave this company. (My translation.)

The above description illustrates the important role of the founders in building an organisational culture as argued by Schein (2004). Schein (2004, p. 227) suggests that:

> founders usually have a major impact on how the group initially defines and solves its external adaptation and integration problems. Because they had the original idea, they will typically have their own notion, based on their own cultural history and personality, of how to fulfill the idea. Founders not only have a high level of self-confidence and determination, but they also typically have strong assumptions about the nature of the world, the role that organizations play in that world, the nature of human nature and relationships, how truth is arrived at, and how to manage time and space.

Furthermore, the institutionalisation of conservatism is performed by the Board of Directors. The manner in which the Board of Directors institutionalises conservatism is similar to that of the founders. This can be seen from a statement by the President of the Board of Directors at the 2004 Management Annual Meeting held on 4 February 2004. She said:

> On behalf of management, I would like to thank you all who have successfully performed jobs that increased the company's performance. We again would like to remind all employees that this business is run to provide benefits not only for a certain group, but also for shareholders, management and employees, clients and society. We have moral responsibilities to remind each other and control those who abuse power for their self-interest...It is not easy to split those with ethical conduct from those with unethical conduct. We have tried to do that. We also have codified all matters related to the rights and responsibilities of employees in *Kesepakatan Kerja Bersama* (Mutual Working Agreement), as a code of conduct. Indeed, The Office of Labour Force said that there is no working agreement as complete as the agreement set by *Bintang*. I feel embarrassed to codify this conduct, as it appears that I have a lack of trust in my employees. (My translation.)

The use of desk calendars is another example of how conservative attitudes are internalised in *Bintang*. Indeed, the calendar exhibits the business philosophy, vision, mission and the culture of *Bintang*, which are intended to remind all organisational actors of the conservative attitude.

For example, in the 2004 August sheet of the calendar, there is a statement that reads: "In passing a journey of time, a philosophy is always attached in the company, that is, our business is built on three integrated interests: shareholders, directors and employees, and customers and societies". This statement is symbolised by a picture of three-chained clips. Such a calendar reminds its members to focus their conduct on the principles of public accountability, transparency and ethical business.

The above statements and examples indicate that conservatism has been successfully institutionalised in *Bintang*. In this regard, Mr D said on 23

September 2004 that:

> ...the value [conservatism] drives me to be an honest and hard worker. I think the implementation of this value in *Bintang* runs well and has been socialised by the directors. (My translation.)

Another employee in the Accounting Division, Mr F, when starting work at *Bintang* was asked to accept its corporate culture, including a conservative attitude. He said on 21 September 2004 that:

> ...when working in *Bintang*, we are asked to be honest and work as a team and to have a balance between personal interests and company's interests. (My translation)

Referring to the work of Berger and Luckmann (1984), it can be seen that conservatism as an institutionalised belief was initially the founder's habit, and was externalised by the founders. Through personal expression and behaviour, the reality of conservatism can be observed and is experienced by all organisational members. This then becomes *habitualised* action in *Bintang*. Conservatism is finally internalised in *Bintang* through formal and informal socialisation performed by the Board of Directors. Similarly, Hallett (2003, p. 130) claims that:

> …when people enter organizations, they bring their habitus—and their relation to the broader social order—with them...In completing organizational rules, people act on the basis not only of organizational rules, but also of the habitus.

This view signifies that even though culture is "created by shared experience", it is the founder or leader who initiates such creation "by imposing his or her beliefs, values and assumptions" (Schein 2004, p. 225).

Moreover, Munro and Beeson (2002) remark that the founders of an organisation not only establish the framework of an organisation's culture through their personalities and behavioural preferences, but also make early assumptions about how to deal with issues within an organisation. They (2002) continue to argue that initially founder's assumptions are not generally accepted by the organisation as a whole. However, as the assumptions are perceived as successful, such assumptions begin to be taken for granted as the way an organisation operates. As a result, the assumption becomes part of the underlying culture.

In relation to financial reporting practice, it can be argued that conservatism has influenced such practice. Conservatism, as a part of *Bintang*'s organisational culture, has shaped its organisational members to conduct ethical and transparent financial reporting. This is because culture consists of normative values, which will determine systematic choices of an organisation in explaining social phenomena. Accounting systems as social institutions should be able to reflect such postulates (Violet 1983).

The following narratives illustrate the extent to which conservatism has determined ethical and transparent financial reporting in *Bintang*. The Director of Administration Service said on 8 September 2004 that:

> The quality of financial reports is mainly determined by ethical conduct of those who prepare the reports. If you are used to run business ethically, you will automatically provide the true information of company activities. (My translation.)

The Director of Financial Service agreed with the statement, and maintained on 24 August 2004 that:

> Producing a quality financial report might be not a commitment. I do not really know. That is *Bintang's* way of doing business. We are used to transparent business practice. Historically, we are institutionalised to do that. This [transparency] is the character of *Bintang*. (My translation.)

Apropos to obedience to regulations and the Indonesian business environment, he (the Director of Financial Services) argued that:

> ...a financial statement is partly influenced by regulations. The rest depends on us. The way we practise is the determinant of quality financial reports. But unfortunately, a number of people have different interpretations on the regulations and tend to interpret them in a wrong way. The jargon in our society in regard to regulations is that "if we can provide incomplete information, why do we have to provide complete information? If we think it is not necessary to make a report, why are we busy with the report?" We do not agree with this point of view and never want to act like that. (My translation.)

This statement indicates that how individuals in *Bintang* choose their actions depends on the way they socially define and personally accept moral constraints. For Durkheim (1961), individuals voluntarily submit to the "discipline", in terms of norms and values, of social groups to which they belong.

Statements by those who are directly involved in *Bintang* show that conservatism has been successfully internalised and it has constructed a financial reporting practice in *Bintang*. Interestingly, in such a practice the leaders of *Bintang* have been able to show their conduct as an exemplary model for their subordinates. In relation to this, Mr D in the Accounting Division believed on 23 September that:

> …the reason why we got the annual report award is that we have honest leaders. They never have an intention to manipulate accounting data. That is our culture... conservative. (My translation.)

The above quotations also demonstrate that as conservatism concerns moralities, organisational managers will avoid acting in ways that depart drastically from the moralities that pertain in the institutional context in which the organisation operates (Morgan 1998; Zucker 1988). Consequently, conservatism becomes embedded in financial reporting practice.

What can be learned from *Bintang* is that quality financial reporting practice is strongly influenced by the organisational culture of the company. It is true that regulations affect financial reporting practice. However, compliance with regulations is determined by organisational culture. Thus a company with an ethical culture will more likely be committed to compliance with regulation and to quality financial reporting practice.

To build and manage an ethical culture is not an easy task. Nevertheless, with appropriate approaches such as socialisation, monitoring and ethical leadership as an exemplary model for subordinates, ethical culture can be observed and experienced by all organisational members. Through these approaches, ethical culture can be properly institutionalised and will be eventually embedded within an organisation. This is consistent with the argument by Oliver (2004), who states that building an ethical culture is not a natural process. Indeed, as he contends, it requires a combination of clear systems and approaches, substantial employee training programs, incentives, monitoring and example setting from the top.

In line with the lesson from *Bintang*, it might be interesting to consider a report issued by the National Association of Corporate Directors in 1998 (cited by Geriesh 2003). The report, *Report on the NACD Blue Ribbon Commission on CEO Succession,* concluded that the primary responsibility for the prevention and detection of fraud rests with management, boards of directors and audit committees. Hence, as the report suggested, management should create organisational culture that is able to deter fraud and should set clear corporate policies against improper conduct.

In addition, Geriesh (2003) shows a number of studies concluding that companies convicted of illegal actions have a history of prior violation, and have a corporate culture that condones wrongful activities. She continues to argue that such illegal behaviour begins with minor violation, develops into culture that sanctions illegal behaviours and eventually leads to fraudulent financial reporting. This implies that a certain company builds organisational culture and complies with regulation for symbolic actions. The company claims that it adopts ethical culture that supports quality financial reporting practice, but in reality they are not committed to quality financial reporting practice. Institutional theory calls this behaviour as “decoupling”.

## 7.5 DECOUPLING: A NOTE TO INSTITUTIONALISM

"Decoupling" is an interesting issue addressed by institutional theory. Meyer and Rowan (1977, pp. 340–341) define decoupling as the activity whereby

> to maintain ceremonial conformity, organizations that reflect institutional rules tend to buffer their formal structure from the uncertainty of technical activities... building gaps between their formal structures and actual work activities.

Decoupling shows a distinction between the formal structure of an organisation and its actual day-to-day activities. The formal structure is seen in terms of myths and ceremonies, and does not necessarily correspond to technical efficiency.

The adoption of socially accepted practices may not improve the efficiency of an organisation's activities. However, gaining an acceptable public image is important for an organisation to survive. For Carruthers (1995, p. 315), the adoption of certain formal structures is more concerned with "the presentation of organizational-self than with how things actually transpire within an organization", and is a kind of "symbolic window dressing" for organisational survival. In other words, there is a "decoupling" between what is claimed and what is practised, and between formal adoption and actual implementation.

This disconnection between the adoption of a practice and its *implementation* could also be applied in financial reporting practice. Companies claiming compliance with certain accounting standards do not implement them completely. Studies by Shah (1998) and Rutherford (1999) showed evidence of decoupling in the application of accounting standards. These studies imply that the reason companies comply with accounting standard is to gain legitimacy, even though the companies do not really implement all standards in their financial reports.

However, decoupling in financial reporting practice does not occur in *Bintang*. Indeed, *Bintang* always obeys regulations, adopts an ethical practice and is committed to quality financial reporting practice. According to Ashforth and Gibbs (1990), to gain legitimacy through financial reporting practice, *Bintang* prefers to adopt a substantive approach rather than a symbolic approach. Moreover, in light of Oliver's (1991) strategic responses, *Bintang* has employed the strategy of acquiescence through conformity to institutional pressures.

A number of annual reports awards are convincing evidence of *Bintang's* commitment to transparent practice. Again, the reason for this is the organisational culture of *Bintang*. Either with or without regulations, *Bintang* always produces and publishes transparent annual reports. In this regard, Phelan (2005, p. 55) concluded that "an organizational culture of consistent behavioural norms is not only a powerful motivator of efficient and productive employee behaviour; it is an. important element of organizational mental health". This is the way *Bintang* has conducted financial reporting practice to gain legitimacy form its constituents and to maintain social harmony.

## 7.6 CONCLUSION

This chapter discussed the process by which *Bintang* is committed to quality financial reporting practice. It is claimed that financial reporting practice is a socially constructed reality. It is shaped by actors of *Bintang*, external actors and institutional and cultural environment. Hence, such a practice is an institutionalised routine that becomes a ritual in *Bintang*.

The financial reporting practice in *Bintang* also shows that organisational culture plays a crucial role in providing transparent information. This is because the organisational culture of *Bintang* is built on the principle of public accountability and conservatism. Interestingly, the organisational culture of *Bintang* reflects the Javanese view of ethical social relationships. This organisational culture is built for the purpose of maintaining social harmony. In addition, such a culture is maintained and managed by organisational actors, from those in the top position to those in the lower position. Actors in top positions manage and maintain organisational culture through ethical conduct that is seen by subordinates as an exemplary model, whereas subordinates directly observe and experience customs, values and beliefs practised in *Bintang*. Through this process, institutionalisation of *Bintang*'s organisational culture run successfully and become embedded within *Bintang*.

The case of *Bintang* provides an interesting insight into the relationship between organisational culture and financial reporting practice. The case implies that it is not difficult to claim that a company with ethical culture is more likely to be committed to quality financial reporting practice than those with unethical cultures. However, it is important to note that as culture is not a static phenomenon, its implementation into financial reporting practice needs a powerful actor who behaves according to the values accepted in *Bintang*. In addition, other parties outside *Bintang* are likely to play a role in shaping financial reporting practice. This means that power and politics become another phenomenon that shapes financial reporting practice.

Individuals with different backgrounds and skills will have different views in regard to the power they have and roles they play in financial reporting practice. Consequently, financial reporting practice is a political practice involving power and influence. This will also involve the role of leadership and power mobilisation in forcing all actors to be committed to quality financial reporting practice. The next chapter will discuss financial reporting practice from a perspective of power.

# CHAPTER EIGHT
# POWERFUL ACTORS BEHIND THE SCENE: LEADERSHIP AND POWER MOBILISATION IN FINANCIAL REPORTING PRACTICE

## 8.1 INTRODUCTION

As mentioned in Chapters Six and Seven, the reason why *Bintang* is committed to quality financial reporting practice is that such practice enables the company to build a positive image of its activities to gain legitimacy and to maintain social harmony. As such, the organisational culture of *Bintang* is built to drive its organisational members to obey governing regulations and to act in accordance with socially acceptable values and norms.

It is also pointed out in Chapter Seven that building organisational culture is not a natural process. Instead, it must be deliberately developed and managed so as to set organisational culture to fit with institutional environments. In so doing, leadership plays an important role in developing and managing culture (Schein 1995; 1996; 2004). With their position and personal power, a leader should exercise power to influence organisational players to be committed to quality financial reporting practice. In other words, a leader should mobilise power to accomplish such practice.

The case of *Bintang* is useful to describe how leadership and power mobilisation play important roles in constructing quality financial reporting practice. Because financial reporting practice, as a part of accounting activities, is value laden (Hines 1988; Miller 1994; Morgan 1988; 1998; Munro 1998), the use of Javanese philosophy on power and leadership will be useful to understand how quality financial reporting has been practised in *Bintang*.

This chapter will discuss powerful individuals behind the financial reporting practice in *Bintang* and how leadership and power mobilisation occur in the company. The first section of this chapter will describe a leadership style in *Bintang* and its influence on financial reporting practice. This will be followed by a section discussing how power is distributed symmetrically among powerful players in *Bintang* to create a balance of control. Before a conclusion is drawn, this chapter includes a discussion of power mobilisation, as proposed by Hardy (1996), to analyse how the actors use strategies in exercising power.

The following section will discuss how *Bintang* has employed such a leadership approach to build transparent and ethical business practice, including financial reporting.

## 8.2 LEADERSHIP IN *BINTANG*: WE COPY OUR BOSS' BEHAVIOUR

### 8.2.1 The Role of a Leader in *Bintang*

In Indonesian society, as a paternalistic society, leadership plays a significant role in the success of any endeavours. The ways they behave and exercise power will definitely influence other individuals. Within the context of the business environment, a leader can be anyone who is able to exercise power to influence others. Leaders can be a board of directors, a board of commissioners, internal auditors, an audit committee, or other top managers.

With respect to *Bintang*, it can be argued that its leadership style is influenced by the Javanese philosophy rather than Western thought. This is because how *Bintang*'s leaders behave is apparently to reflect the Javanese view on social relationship. To quote Watson (1998, p. 267), "the activities of those who have power and discretion within organisations both shape and are shaped by the societies to which they relate". Moreover, Javanese culture has influenced the management style of most Indonesian companies and individual's behaviours in organisations (Hofstede 1982).

In *Bintang*, the relationship between superiors and subordinates is seemingly a father–child relationship. Even though the company is not a family-owned company, it is managed under a family type of management. Thus, the figure of *Bapak*-father plays an important role in the success of the company including in financial reporting practice. The role of the head of the company or a senior executive is very important, especially as a problem solver, agent of change, initiator, internal consultant and decision maker. In regard to this, Yudianti and Goodfellow (1997, p. 106) assert that:

> …[l]eadership is especially important in Indonesian companies, because most subordinates lack an appreciation of basic initiative. This is compounded by a pervading spirit of passivity, which manifests itself as a lack of self-confidence. It is a dominant theme across most of Indonesian society, and is believed to result from a strong tradition of paternalism and feudalism, particularly in Java.

The role of leaders in *Bintang* are, thus, vital because the leaders are responsible for building and managing organisational culture and undertake a direct responsibility for their subordinates. In addition, it seems that leaders in *Bintang* take almost all of the initiative, with subordinates obeying and following.

An example of this can be seen from an event when Mr G was being interviewed for this research on 15 September 2004. The interview was interrupted because his mobile phone was ringing. From his conversation, it was clear that someone was asking Mr G to decide a problem, which was related to a new client and underwriting policies for which he is responsible. However, in spite of making a decision, Mr G responded to the caller as follows:

> We cannot do that [accept a new client]. This is a shopping centre and its risk is possibly higher than the targeted risks. Just tell him [the client] we cannot accept his request...Have you called *Ibu* Ari [the President of the Board of Directors]? Please call her first and ask her for advice. (My translation.)

This statement shows that based on *Bintang*'s underwriting policies, the Manager of the Underwriting Division should be able to make a decision on the issue. Nonetheless, he suggested calling the President of the Board of Directors to discuss the issue.

In *Bintang* a leader to some extent becomes dominant and subordinates will imitate and follow whatever the leader does. This means that an ethical leader will create ethical subordinates because such a leader, as Adams, et al. (1996) claim, will be a strong factor in determining the ethical standards and climate of the business. Within this view, organisational members of *Bintang* will feel uncomfortable and embarrassed at diminishing the reputation of their leader if they do not follow what the leader does. Apropos of this, it is important to note a statement by a staff member in the Accounting Division regarding the success of

*Bintang* in winning a number of annual report awards. Mr E said on 21 September 2004:

> ..for me as an employee, everything depends on my leader. I heard from my friend who works at another company about this [financial reporting practice]. He said "I have done the right thing in preparing financial reports but my boss asks me not to do so" This never occurs in *Bintang*...As long as my leader asks me to do that, it is up to him [or her]. They will be responsible for that. If someone asks me about my work, I will say: "it is not my work but it is my boss who requests me to do so". However, it has not occurred here...(My translation.)

The above quotations signal that the leadership philosophy of *Bintang* encompasses the Javanese view on leadership. This describes the fact that "the socio-cultural environment determines management beliefs, values and assumptions of workers and work behaviour that characterise the organization's work culture" (Kanungo and Mendonca 1996, p. 109). *Bintang* has been managed within the framework of collectivism with a leader as a figure of *Bapak*-father.

What leaders have undertaken in managing *Bintang,* within the framework of *collectivism* and *bapakisme,* might lead to problems such as integration of organisational members and work alienation. However, it is helpful to cite the argument by Kanungo and Mendonca (1996, p. 119) that problems with integration of organisational members, which usually surround organisations run by collectivism, can be overcome by the use of a family metaphor: "this company is one big family in which we are responsible for each other". Indeed, with a Javanese leadership style and collectivism (*kebersamaan*) and self-sufficiency of the company, *Bintang* has been run like a family with a leader as a *Bapak*-Father figure.

In relation to a problem of work alienation, Kanungo and Mendonca (1996, p. 119) believe that such a problem can be reduced “by the idealization of organizational and work values, through organizational socialization practice and by setting up performance-contingent reward systems”. The implementation of *Kesepakatan Kerja Bersama,* as a code of conduct, and the use of *Sismajaprima,* as a system of performance evaluation, are examples of how *Bintang* overcomes such a problem. In addition, Lord and Brown (2004) argue that a leader who triggers followers’ self-construal in terms of the collective, leads followers towards feeling, thinking and acting on behalf of the collective’s norms.

Furthermore, consistent with Javanese culture, *Bintang* maintains that problems and conflicts among stakeholders are resolved by *musyawarah* and *mufakat* (consensus not confrontation). Thus, by the concept of a sense of belonging-*rukun*, it is the role of a leader to overcome any disputes involving both employees and other stakeholders. To quote Singh and Bhandarkar (1990),

> …a sense of belonging to an organization as a family is created among followers when they find that the leader is (a) impartial, that is, fair and firm; (b) open, available, and accessible; (c) concerned with improving their quality of work life; (d) sociable and collegial with them and their families; and (c) respectful and supportive of the authority and position of others, particularly those in the second-line positions of executive succession (cited by Kanungo and Mendonca 1998, pp.119–120).

Considering the above views, the implementation of Javanese leadership style in *Bintang* is guided by a belief that successful leaders are those who act so as—according to Javanese etiquette to show subordinates that leaders are exemplary models for them.

### 8.2.2 Leadership as an Exemplary Model

As discussed above, a leader plays a crucial role in *Bintang*. It is also mentioned in Chapter Seven that the leaders of *Bintang*, from the Board of Commissioners to the top management team, contribute a massive role in shaping an organisational reality, especially in institutionalising the organisational culture of *Bintang*. In light of Javanese ideas, it can be argued that *Bintang* has implemented the Javanese style of leadership characterised by *Tri Pakarti Utama*. Most importantly, leaders in *Bintang* are able to show to their subordinates how the leaders behave ethically in the organisational life of *Bintang*. Indeed, they are an exemplary model for their subordinates. Most employees in *Bintang* claim that leadership, as an exemplary model, is very important in creating ethical and transparent business practice, including financial reporting practice. The Director of Administration Services pointed out on 8 September 2004 that:

> I think the implementation of good corporate governance principles is not because of regulations but an individual mentality. Thus, it is important for directors to communicate and show ethical conduct-as an exemplary model—for subordinates. If this is not practised in this company, I believe that it is difficult to implement such principles in the lower structural positions. *(*My translation.)

This quotation reflects a view by Kanungo and Mendonca (1996), that although any codes of conduct are undoubtedly indispensable to the development of the organisation's moral environment, it is the leader's personal conduct that determines the effectiveness of the codes. Moreover, Maclagan (1998) remarks that morality is an important aspect in managing an organisation.

The above statement is supported by those who are in lower positions and who deal with a routine in accounting activities. For example, Mr D in the

Accounting Division agreed that leadership in *Bintang* has influenced the behaviour of its organisational members, and said on 23 September 2004 that:

> ...leadership here is good...We work in a transparent environment...I think the leaders have been able to show their ethical behaviour to employees. They give me an exemplary model of how to work here. (My translation.)

Mr D also believes that a leader should play a role as a figure of *Bapak*-father and should provide a solution to any problems (Yudianti and Goodfellow 1997). He (Mr D) said:

> I see the newcomer [the candidate of the head of the Accounting Division] is very kind. He not only works here but also teaches us. If I have no ideas about certain transactions he will teach me. I often spend my time personally discussing things with him when I have a problem. (My translation.)

Meanwhile, in regard to the current head of the Accounting Division who will resign, Mr D described his boss as an individual who is ethical, kind and speaks only when a mistake occurs.

> *Pak* [Mr] Johny Moring is an ethical and fair leader. If he is angry, he is only angry when he sees his subordinates making unnecessary mistakes. But, after that everything will run normally. He does not hold on to his anger. I like this type of leadership. (My translation.)

The above quotations signal that leaders of *Bintang* understand well problems faced by their subordinates. For this, Hunt and Laing (1997, p. 40) maintain that "successful leaders recognise and articulate a flaw which both humanises and focuses on their followers' dissatisfaction". In Schein's (1995, p. 238) words, leaders are "especially likely to introduce humanistic, social services, and other non-economic assumptions into their paradigms of how an organisation should look". In addition, the above descriptions reflect a claim by Simpson

(2004, p. 73) that "the only time the boss speaks to anyone is when something is wrong".

In line with a gender bias issue, employees in *Bintang* view that such an issue is not important in describing leadership. Indeed, if their leaders are men or women it is not a major problem as long as they are able to show ethical conduct as an exemplary model for subordinates. The Director of Administration Services, who deals with human resources management, argued on 8 September 2004 that:

> …as far as leadership is concerned, *Bintang* has been successfully led by women... She [the President of the Board of Directors] has been able to show her ethical conduct and worked very hard...sometimes until late night. As a man I am motivated by such behaviour... (My translation.)

This narrative signifies what Kanungo and Mendonca (1996) describe as an effective leader, which is an individual whose behaviour is motivated by altruistic motives. Moreover, Driscoll, et al. (1998) believed that effective leaders are exemplar or role models who use their conceptual, interpersonal and theatrical skills to influence others. In light of Schein's (1996, p. 61) work, leaders in *Bintang* are able to shape the mentality of their subordinates "by developing his/her own behaviour as a model that encourages subordinates to identify with them and thereby internalise [his or her] beliefs, values, and assumptions". Thus, to quote Lee (2004, p. 48), the important aspect of leadership is "how leaders at all level transform individuals' attitude and abilities so that they align with the organisation's strategy and culture".

In financial reporting practice, it can also be argued that leadership is seen as a key factor affecting quality financial reporting. An ethical leader will likely promote a higher quality of financial reporting than an unethical leader. In *Bintang*, it is claimed that even though a leader, for example, the President of the Board of Directors, has a chance to manipulate accounting data for her vested interests, she claimed that such behaviour has no place in *Bintang*. She argued on 16 September 2004 that:

> ...what is meant by quality financial reports are reports that fairly present what is really going on in the company. We must be honest in reporting information. For example, if our performance shows a negative figure we might be able to manipulate data or information to make it look favourable. But we always think...what are the benefits of doing such a practice? I think it is not necessary to manipulate data. If other companies do that, it is their choice. (My translation.)

What is said by the President of the Board of Directors is in congruence with a view by March and Olsen (1989, p. 22) who emphasises that:

> …behaviour is contained or dictated by cultural dicta and social norms. Actions are often based more on identifying the normatively appropriate behaviour than on calculating the return expected from alternative choices.

A claim by the President of the Board of Directors is supported by a staff member in the Accounting Division. Mr F whose job deals with accounting and taxation claimed on 21 September 2004 that the top management team consists of honest people and has no role in manipulating accounting data. The following quotation expresses his concerns.

> *Bintang* never manipulates data and top management never asks me to manipulate data. I think quality financial reporting is mainly determined by the honesty of actors involved in such reporting. (My translation.)

Furthermore, the head of the Internal Audit Unit, who has access to the company's information from the top level of management to the lower level of management, contended that leadership, through ethical conduct, plays significant roles in shaping financial reporting practice. He highlighted on 9 September 2004 that:

> ...we also have an honest Board of Commissioners who do not have a negative reputation. The Board of Commissioners always shows ethical conduct, as an exemplary model for all employees here... (My translation.)

The case of *Bintang* indicates that "effective leaders use a variety of behaviors plus oral and written communications to transmit their visions, their differences, and their values" (Hunt and Laing 1997, p. 32).

The above narratives describe that leadership plays crucial roles in influencing financial reporting practice in *Bintang*. In other words, as Oliver (2004, p. 34) claims:

> …[o]rganizational leaders are committed to the principles and spirit of transparency. They embed this commitment into the organisation's communications with stakeholders, its information-gathering processes, and its systems of metrics. Commitment is demonstrated by the standard to which senior leadership holds itself, the documentation and communication of governance processes and metrics, and walking the talk with swift and steady enforcement of transparency and ethics guidelines.

In general, it can be inferred that leadership in *Bintang* reflected the Javanese view on leadership. As Bolden (2004, p. 29) remarks, those who "become a leader, how they behave, and what they do are all determined as much by social and cultural factors as by any individual characteristics". Indeed, the leadership in *Bintang* shows a portrait of Javanese leaders who are able to show an exemplary model for their subordinates (*ing ngarso sung tulodo*), are able to empower subordinates (*ing madyo mangun karso*), and have a sense of responsibility to their subordinates (*tut wuri handayani*). Aligned with the work by Kanunga and Mendonca (1996, p. 35), what is practised in *Bintang* shows that:

> …organizational leaders are truly effective only when they are motivated by a concern for others, when their actions are invariably guided primarily by the criteria of benefits to others even if it results in some cost to self.

Furthermore, Northouse (2004, p. 171) suggests that the major characteristics of charismatic leaders are

> (1) a dominant personality, desire to influence others and self confidence; (2) strong role models behaviour and competence; (3) articulation of ideological goals with moral overtones; and (4) high expectation of followers and confidence that they will meet these expectations.

In line with the role of leadership in shaping quality financial reporting practice in *Bintang*, it is important to take into account what PriceWaterhouseCoopers suggested concerning transparent financial reporting practice. As cited by Oliver (2004, p. 41), the PriceWaterhouseCoopers report, *Transparency in Global Reporting*, emphasised that:

> …rules, regulations, laws, concepts, structures, processes, best practices, and the most progressive use of technology cannot ensure transparency and accountability. This can only come about when individuals of integrity are trying to 'do the right thing', not what is expedient or even necessarily what is permissible. What matters in the end are the actions of people, not simply their words.

This statement signifies that financial reporting practice is a people-centred process concerning supply of information. Thus, ethical conduct of actors involved in such a practice will determine the quality of financial reporting. Leadership in *Bintang*, as discussed above, is a critical factor in shaping organisational members to be committed to the quality financial reporting practice. Indeed, to build a transparent organisation, leaders should "create programs and processes that institutionalise transparency and make it an essential function and trait of the organization..." (Oliver 2004, p. 35).

Because leadership involves influence and influence needs exercise of power, actors involved in the preparation and overseeing of such practice need equal distribution of power. This distribution of power will determine whether an individual is powerful or powerless in regard to their role in financial reporting practice. The following section will discuss how symmetry of power implemented in *Bintang* is able to create balance of control in financial reporting practice.

## 8.3 SYMMETRY OF POWER CREATES BALANCE OF CONTROL

It is believed that a problem with a corporate governance mechanism concerning financial reporting practice is mainly caused by ineffectiveness of actors in performing their roles in the mechanism. The main reason for such ineffectiveness is that power is distributed asymmetrically among the actors. In other words, to create quality financial reporting practice, a balance in distribution of power among individuals involved in the mechanism is needed. The case of *Bintang* provides interesting evidence of how symmetry of power creates balance of control and drives commitment to a transparent financial reporting practice. The following section will discuss the implementation of a corporate governance mechanism as a basis of discussing power distribution among actors involved in the mechanism.

### 8.3.1 Implementation of Corporate Governance in *Bintang*

The story of *Bintang*, as described in Chapter Five, exhibits that a corporate governance mechanism plays an important role in managing business practice, including financial reporting practice. Hence, the implementation of good corporate governance principles is seen by organisational members of *Bintang* as not only mandatory but also moral obligation. In other words, using the terminology of Ashforth and Gibbs (1990), *Bintang* does not adopt such principles as a "symbolic management strategy", but as a means of ethically managing insurance business. Indeed, its organisational culture stimulates such implementation.

Statements by those who are directly involved in the implementation of good corporate governance principles will be useful to understand such implementation. For example, Mr G who deals with the underwriting policies of *Bintang,* claimed on 15 September 2004 that:

> good corporate governance principles have been currently implemented in *Bintang*...Such principles have been implemented by directors for internal improvement. This can be seen from the current programs intended to clean *Bintang* from those who neglect our culture. (My translation.)

Another staff member also supports such an implementation. Mr A in the Accounting Division highlighted on 3 September 2004 that:

> I think *Bintang* has been implementing good corporate governance principles even though *Bintang* is still struggling to make such implementation perfect. (My translation.)

The implementation of good corporate governance principles is claimed to be crucial to *Bintang* in running an ethical business, especially in the Indonesian business environment, which is surrounded by unethical business practice. In this respect, the Director of Financial Services, who previously worked at two different companies before he returned to *Bintang*, justified such a claim on 24 August 2004:

> I think the implementation of good corporate governance is very important for the insurance business. We believe that transparent management is very useful for the insurance business...But it is sometimes difficult to run a transparent business. For example, commission is common in insurance business. However, the problem is that there is not only a legal commission but also an illegal commission...take it or leave it. This condition can lead to dirty business. As *Bintang* is committed to ethical business, we suffered from this problem when we competed with other insurance companies, which enjoy this illegal practice. (My translation.)

Within such a business environment, ethical business can only be run in a condition in which a company is equipped with a good corporate governance system and an ethical culture. Such a system and culture will prevent a company from possibility of corruption and fraud. The Director of Administration Services claimed on 8 September 2004 that:

> If only one person makes decisions, the likelihood of corruption, collusion and nepotism is higher. If decision makers have good ethical conduct, it will not be a problem to let one decision be made by one person. However, we do not rely on one person. We rely on a good system [good corporate governance mechanism]. (My translation.)

The above description shows how *Bintang* has struggled to implement good corporate governance principles even though the business environment in Indonesia does not support ethical and transparent business practice. In the case of

*Bintang* it can be seen that the success of such implementation to a large extent depends on organisational culture and leadership. The most successful implementation of good corporate governance principles in *Bintang* is a principle of transparency, as discussed below.

### 8.3.2 Transparency: the Most Successful Implementation

In *Bintang* the principle of transparency is the most successful implementation of good corporate governance principles. *Bintang* can be seen as a company that is able to provide transparent and reliable information to the public. This can be inferred from the following narratives. The President of the Board of Directors said on 16 September 2004 that:

> …we adopt good corporate governance principles issued by the National Committee on Corporate Governance. What has been implemented successfully is transparency. Indeed, some people told me that my company is too transparent, which enables my competitors to steal my policies or strategies. (My translation.)

The reason for this success is that transparency has been seen as a taken-for-granted belief in *Bintang*. In fact, Oliver (2004) points out that commitment to transparency needs an ethical culture. The practice of transparency is accepted as a part of *Bintang*'s ethical culture, which guides daily activities of its organisational members in conducting business. A quotation by the Director of Financial Services on 24 August 2004 illustrates the extent to which transparency is accepted as a taken-for granted belief:

> Producing a quality financial statement is actually not commitment. I do not really know. That is *Bintang*'s way of doing business. We enjoy transparent business practice. Historically, the founders institutionalised such a practice. This [transparency] is the character of *Bintang*. We previously did not know what good corporate governance was. But when issues of good corporate governance emerged in Indonesia, we were not surprised...The way we govern our company is a reflection of good corporate governance principles. We just made some revisions on our concepts to fit with the code of good corporate governance [issued by the National Committee on Corporate Governance]. (My translation.)

The success of *Bintang* in implementing a principle of transparency is also supported by employees in the Accounting Division. For example, on 21 September 2004, Mr E who is responsible for the accuracy of data presented in financial statements, explained his view on the practice of transparency:

> With the implementation of good corporate governance principles, information requested by the users is available in the annual reports. We have provided the information they need. And now, other companies have copied the way *Bintang* publishes financial statements. When my friend read *Bintang*'s annual reports, he said to me "excellent, this report is very complete and transparent". (My translation.)

In addition, a number of awards gained by *Bintang* are convincing evidence of the success of *Bintang* in implementing the principle of transparency. On 21 September 2004, Mr F justified the implementation of good corporate governance principles as a key success of *Bintang* in winning annual report awards. He said:

> An annual report award is important for *Bintang* because the award can increase public confidence. This is related to the implementation of good corporate governance principles. (My translation.)

The above views, together with arguments discussed in Chapter Seven, show that organisational culture and leadership style are the key elements in driving the people of *Bintang* to be committed to quality financial reporting practice. This refers to Oliver's (2004, p. 31) claims that leadership "bears direct responsibility for creating a culture of transparency...When top leaders have done their parts, individual actions of employees make a transparent culture real".

The financial reporting practice of *Bintang* signals that its actors—especially those who perform and oversee the financial reporting practice, are effective and powerful in playing their roles in constructing such a practice. It seems that there is a balance in the distribution of power among actors in the corporate governance mechanism. For this, the following section will discuss how power is distributed in *Bintang* to accomplish an effective oversight of financial reporting practice.

### 8.3.3 Power Distribution and Effectiveness of Oversight

Theoretically, as argued in Chapter Three, to accomplish an effective corporate governance mechanism that promotes quality financial reporting practice it requires a balance of power among actors involved in the mechanism. Power should be distributed equally among these individuals according to their roles, especially those who are related to financial reporting practice.

An assessment of an individual's power bases and strategies of influence are essential to an understanding of power distribution in an organisation. The successful use of a certain strategy in the exercise of power depends on supporting power bases, power bases of others, time perspectives and personal styles (Greiner and Schein 1988). Using the source of power discussed by Finkelstein

(1992), actors in any corporate governance mechanism might gain power from four sources: structural power, ownership power, expert power and prestige power. In Greiner and Schein's (1988) words, this power refers to positional power bases (structural and ownership power) and individual power base (expert power and prestige power).

In *Bintang*, besides an ethical culture, the balance of power among actors is seen as an essential element in creating an effective control of financial reporting practice. There are at least four actors who are seen as powerful in supervising the Board of Directors of *Bintang* in setting and implementing company policies, and in shaping financial reporting practice: the Board of Commissioners, the audit committee, external auditors, and internal auditors.

#### 8.3.3.1 Board of Commissioners[57]

Theoretically, the board of commissioners is seen as an important part of the corporate governance structure for the purposes of supervising manager behaviour. To quote Rezaee (2002, p. 126), in running its roles, the board of commissioners should:

a. monitor management plans, decisions, and activities
b. act as an independent leader that takes initiatives to create shareholder value
c. establish guidelines or operational procedures for its own functioning
d. meet periodically without management presence to assess company and management performance and strategies
e. evaluate its own performance to ensure that the board is independent, professional, and active.

[57] To avoid confusing terminology and to focus an analysis on the Indonesian environment, the phrase "board of commissioners" will be used to replace "board of directors" as widely discussed in corporate governance literature, whereas "board of directors" in the Indonesian context refers to chief executive officers (CEO) as used in common literature.

The effective and responsible board of commissioners plays a crucial role in promoting quality financial reporting because the board of commissioners is able to prevent, detect and decrease the possibility of fraud. The roles and responsibilities of the board of commissioners imply that this board should hold power and be able to exercise the power. The board of commissioners might gain power from structural position, ownership, expertise, and prestige. With this source of power, the board of commissioners should be able to play the role of monitoring the board of directors. To quote Finkelstein (1992), the board of commissioners, as a representative of shareholders, can create uncertainties for the board of directors.

Even though it is recognised that the board of commissioners have little influence, those with significant outside shareholders have the power to limit managerial discretion (Hambrick and Finkelstein 1987). Furthermore, Beasley (1996) claims that the composition of the board of commissioners affects the effectiveness of the boards in preventing and detecting financial statement fraud.

In *Bintang*, it can be seen that the roles of all members of Board of Commissioners tend to be reactive not proactive. Currently, within *Bintang*, the Board of Commissioners has two power bases. In light of Finkelstein's (1992) concept of power bases, members of the Board of Commissioners whose backgrounds are founders or a family of founders gain power from "prestige power" that comes from their charisma and their figures as *Bapak*-father; whereas the power base of independent commissioners is expertise that comes from educational background and business experience. In *Bintang*, the Board of

Commissioners places trust in the Board of Directors. Regarding this, the President of the Board of Directors claimed on 16 September 2004 that:

> …to be honest, as members of the Board of Commissioners put so much trust in the Board of Directors; their interventions are not relatively significant. But for me, this means that they do not concern the company. What I wish is that they are really concerned with this company by holding a regular meeting. (My translation.)

This description is in harmony with the claim by Adams, et al. (1996) that founders and first-generation employees rely more on personal identification and trust than on formal rules, structure and job description.

The Board of Commissioners will be actively involved in a meeting if they report emerging issues on the insurance business. Nevertheless, as all commissioners sign financial statements, they have exercised power to monitor company policies and performance, including financial reporting practice. The Director of Financial Services argued that although the Board of Commissioners is not proactive, its roles in solving company problems are important. He said on 24 August 2004:

> …as far as I know the Board of Commissioners is not directly involved in daily activities. Initiatives to have meetings usually comes from the Board of Directors. However, their roles in helping the Board of Directors solve company's problems are very significant. (My translation.)

Interestingly, even if the Board of Commissioners is not actively involved in *Bintang*, the Board of Directors does not utilise this weakness as a chance to behave opportunistically for vested interests. There are two reasons for this behaviour. First, the organisational culture of *Bintang*, which is built by the founder, who is also the Chairman of the Board of Commissioners, has shaped its organisational members to obey rules and regulations and to behave ethically as an exemplary model for subordinates. Consequently, any of the Board of Directors will feel guilty if they behave unethically, because this behaviour shows disloyalty to the members of the Board of Commissioners, who are seen as figures of the kind and caring *bapak*-father. Such behaviour could lead to social disharmony in *Bintang*, a condition that diverges from Javanese culture. The head of the Internal Audit Unit highlighted the following view on 9 September 2004:

> We always obey regulations...We also have an honest Board of Commissioners that does not have a negative reputation. The Board of Commissioners always shows ethical conduct as an exemplary model for all employees here. This will make the Board of Directors or management reluctant to engage in unethical business by breaking the regulations. (My translation.)

The expression of “reluctance” (*pakewuh*, *sungkan* in Javanese) to deal with unethical business is an attitude that individuals should understand in avoiding a conflict in a social relationship. To quote Legge (1998, p. 159), “individuals in both an organization and a society should behave so to achieve forms of self-actualisation that leads to social harmony”.

Second, the inactive involvement of members of the Board is overcome by the active role of the independent commissioner, who also acts as the Chairman of the Audit Committee. Indeed, the independent commissioner plays an active role as a mediator between the Board of Commissioners and the Board of Directors, as well as external auditor. Regarding this role, the Director of Administration Services, who is also a minority shareholder and was previously an independent commissioner, affirmed on 8 September 2004 that:

> ...the Board of Commissioners performs its duties through "the hand" of the Audit Committee. The Audit Committee works together with internal auditors. This is a control mechanism in governing this company...The members of the Board understand their roles that cause them not to be involved directly in the company. (My translation.)

In addition, the active involvement of the independent commissioner is supported by the President of the Board of Directors. On 16 September 2004, she remarked:

> In recent years they [the Board of Commissioners] have paid more attention to *Bintang*, especially when we have an independent commissioner. The independent commissioner has been able to hold a regular meeting, and always asks the Board of Directors to attend it. (My translation.)

This description signals that the Board of Commissioners has power, and has exercised it to supervise the Board of Directors. However, it should be noted that the key success factor in the effectiveness of a control mechanism in *Bintang* is the active role of the Audit Committee, whose chairman is an independent commissioner. The following section will discuss the Audit Committee of *Bintang*

**8.3.3.2 Audit Committee**

Within a corporate governance mechanism, the audit committee can be seen as a committee consisting of non-executive and independent board of directors. Wild (1994) found that the audit committee both enhances managerial accountability to shareholders and is an effective component of corporate governance.

In *Bintang*, the Audit Committee plays a crucial role in shaping transparent and ethical business practice, including financial reporting practice. In line with this claim, the President of the Board of Directors argued on 16 September 2004 that:

> the Audit Committee plays an important role in this company. We have an audit committee charter and an internal auditor charter. As the Chairman of the Audit Committee is also an independent commissioner, the Audit Committee has been successful as a mediator between the Board of Commissioners and the Board of Directors in discussing company policies and issues. Thus, we currently have regular meetings. (My translation.)

This statement is also supported by the Director of Administration Services, but he claimed that the mentality of the Audit Committee is the determinant of the active role of the Audit Committee. He contended on 8 September 2004 that:

> the Audit Committee has been successful in performing their jobs for several reasons. The most important thing is mentality or morality, which is institutionalised by the Board of Commissioners. This mentality is an idea of running an ethical and fair business... (My translation.)

With respect to the above statements it can be argued that the Audit Committee is a crucial part of the corporate governance mechanism, with the functions of improving quality of information flow between the Board of Directors and the Board of Commissioners. This is because the Audit Committee is responsible for monitoring financial reporting practice, internal control structure and audit functions (Rezaee 2002). The ability of the Audit Committee in preventing and detecting the likelihood of financial reporting fraud mostly depends on its effectiveness in exercising power. To make its role effective, members of the Audit Committee must have regular meetings both in a group and in private.

From the case of *Bintang* it can be seen that the Audit Committee has successfully performed its roles. Most employees in *Bintang* recognised the importance of the Audit Committee, especially its role in constructing financial reporting practice. For example, the head of the Internal Audit Unit claimed on 9 September 2004 that:

> ...the Audit Committee is effective enough in influencing company policies…and... in influencing the quality of financial reports...(My translation.)

This view is also supported by his subordinate (Mr B), who believed on 14 September 2004 that :

> Since its establishment in 2001, the Audit Committee has performed it roles very well. They also review the works of internal auditors. Thus, the Audit Committee plays important role in producing accurate financial data. (My translation.)

The Board of Directors also maintained that the Audit Committee plays a significant role in ensuring the quality of financial reporting in *Bintang*. For example, the Director of Financial Services contended on 24 August 2004 that:

> ...they [members of the Audit Committee] strongly influence the quality of financial reports. When we are going to publish a financial report, the Audit Committee and the external auditor have a meeting and ask me to attend. We review a format and content of financial statements and discuss findings of audits. They [members of the Audit Committee] affect the quality of financial reports...*(*My translation.)

The above narratives are in congruence with views by some scholars (Cohen, et al. 2004; DeZoort, et al. 2002; Ng and Tan 2003), who claim that an effective audit committee is indispensable in increasing financial reporting quality.

As previously mentioned, the case of *Bintang* illustrated that the Audit Committee plays a crucial role as a mediator between the Board of Commissioners and the Board of Directors. This can be seen from meetings conducted by the Audit Committee and statements by those who work closely with it. For instance, a narrative by the Director of Financial Services on 24 August 2004 signals the fact that the Audit Committee is a mediator of distributing information from internal auditors, external auditors and the Board of Directors to the Board of Commissioners:

> The Audit Committee is very serious in performing its roles. Initiatives usually come from the Audit Committee. I am always asked by the Audit Committee to attend monthly meetings. For instance, in a meeting, the Audit Committee discusses certain issues or policies with me. The next meeting, the Committee asks me to explain the progress of the issues discussed in the previous meeting. If there is a crucial issue, the Audit Committee will suggest the Board of Commissioners have a meeting. The Committee also makes a report and sends it to the Board of Commissioners. In addition, the Audit Committee receives notes or important information from an internal auditor regarding company policies or accounting issues. (My translation.)

The Director of Administration Services expressed a similar view concerning the role of the Audit Committee as a mediator of information distribution. He claimed on 8 September 2004 that:

> ...the Audit Committee is powerful in monitoring what is going on in *Bintang*… any findings by internal and external auditors will be reported to the Board of Commissioners and this Board will ask the Board of Directors to arrange a meeting to discuss the findings... (My translation.)

The ability of the Audit Committee to arrange meetings, review policies and ensure quality financial reporting shows that it is able to exercise power to influence other powerful actors by "securing the consent of others to assist, collaborate and work with the audit committee" (Cohen 1984, p. 311).

The case of *Bintang* also supports a claim by Collier (1997) that the Audit Committee is a useful device, which provides twin benefits of a link between the non-executive directors (board of commissioners) and the auditors, and the enhancement of information flow to non-executive directors (board of commissioners). Moreover, the effective role of the Audit Committee in *Bintang* is in congruence with a recommendation by the Blue Ribbon Committee (1999). This Committee (1999) claims that quality financial reporting can be achieved only through open and candid communication and close working relationships among the company's Board of Directors (board of commissioners), audit committee, management, internal auditors and external auditors.

The above descriptions of the role of the Audit Committee show that it gains power from structural positions and expertise, and exercises power to shape quality financial reporting practice. This signifies that the Audit Committee of *Bintang* has a great influence over the quality of financial reports. The following quotations signal how the Audit Committee has exercised power to monitor company policies, to improve financial reporting quality and to appoint external auditors. For example, the head of the Internal Audit Unit remarked on 9 September 2004 that:

> ...the Audit Committee is powerful in influencing policies made by directors...[it] is powerful but not selfish. In the case of reviewing a management letter sent to an audit firm, for example, the Audit Committee has an authority to ask directors to complete the letter not for their own interests, but for the interests of the company. (My translation.)

The Director of Financial Services also expressed similar concerns regarding the power of the Audit Committee. He said on 24 August 2004:

> the Audit Committee is also powerful in selecting external auditors. We [the Board of Directors] are not allowed to do so because this can lead to a conflict of interest (My translation.)

As the Chairman of the Audit Committee is also an independent commissioner, the powerful role of this Committee supports Oliver's (2004, p. 31) view that:

> [the Audit Committee] establishes policies that ensure and reward transparency...should diligently monitor [their] implementation to ensure completeness, ensure that facts are not obscured and that conflicts of interest are limited.

The reason why the Audit Committee is powerful in influencing company policies including the financial reporting practice is that its members possess necessary educational backgrounds and experience. This argument is based on statements by *Bintang*'s organisational members. The head of the Internal Audit Unit claimed on 9 September 2004 that:

> ...from the composition of the Audit Committee, *Bintang* has a number of qualified people...We have two members of the Audit Committee who previously worked at Price Waterhouse. They are very concerned with financial reporting practice...Their experience and backgrounds as external auditors might make their work more detailed and technical. (My translation.)

A former external auditor of *Bintang* and the Director of Financial Services also expressed similar views.

> The Audit Committee consists of experienced people who are very professional in accounting and insurance. (My translation from statement by an external auditor of *Bintang*—Mr C, on 7 September 2004.)

> I think this [why the Audit Committee is powerful in affecting financial reporting practic*e*] is because they are expert in accounting and in insurance business. (my translation from a statement by the Director of Financial Services on 24 August 2004.)

The description of *Bintang*'s Audit Committee confirms claims by a number of scholars (Beasley and Salterio 2001; DeZoort 1998; McDaniel, et al. 2002; Rezaee 2002). For example, DeZoort (1998) contended that the audit committee whose members are experienced has a better understanding of the auditor's side in disputes with management and lends supports to the auditor in a squabble. In addition, Rezaee (2002, p. 127) posits that members of the audit committee should be "financially literate, professionally qualified, operationally knowledgeable, and functionally independent to effectively fulfil their vigilant oversight responsibility".

**8.3.3.3 External Auditor**

As a part of an external mechanism, an external auditor is seen as playing a crucial role in ensuring quality financial reporting. To ensure the quality of financial reports, external auditors are engaged to give an opinion regarding the presentation of financial reports, and provide an assertion that they comply with regulations and laws and are free from material misstatement. By virtue of their professional status, an external auditor is deemed to be independent and knowledgeable.

In the case of *Bintang,* external auditors are effective and powerful in shaping financial reporting practice. It is believed that avoiding a conflict of interest is the key aspect of ensuring the effectiveness of external auditors.

*Bintang* changes external auditors every two years. Previously, *Bintang* had appointed a single auditor from 1956 to 2000. A quotation by the President of the Board of Directors on 16 September 2004 illustrated the reason for changing the external auditor:

> We changed the external auditor for two reasons. First, the previous external auditor that had audited my company from 1956 to 2000 was married to a member of the Audit Committee. Thus, to avoid a conflict of interest we changed the auditor. Secondly, we have to obey the regulations, which ask a company to change external auditors regularly [every three years][58]. However, we always appoint the big five firms. (My translation.)

These reasons are also supported by the Director of Administration Services, who is also one of the minority shareholders. He said on 8 September 2004:

> We used the audit firm *Sidharta-Sidharta* for more than 35 years. However, since Mrs Istini Sidharta has been appointed as a member of the Audit Committee of *Bintang*, we appointed another audit firm. We do not want any conflict of interest to exist in this company *(My translation.).*

Furthermore the appointment process of an external auditor is undertaken through the general meeting of shareholders held in July each year. A candidate for the role of an external auditor is usually proposed either by the Board of Commissioners, the Audit Committee or shareholders. The head of the Internal Audit Unit pointed out on 9 September 2004 that:

> a policy to appoint an external auditor is based on a decision made in the general meeting of shareholders. When shareholders agree with the appointment of a certain external auditor, the Board of Commissioners discusses the audit fees. Recommendation to appoint external auditors usually comes from a number of parties, such as the Board of Commissioners, the Audit Committee and shareholders. (My translation.)

[58] This regulation (Number VIII.A.2 Kep-20/PM/2002) came into effect on 22 January 2002.

This statement is echoed by the Director of Administration Services. He said on 8 September 2004:

> an external auditor is appointed through the general meeting of shareholders. This meeting usually gives an authority to the Board of Commissioners to propose a candidate as an external auditor. (My translation.)

One of the criteria adopted by *Bintang* to appoint an external auditor is that an auditor must come from one of the big five firms. The reason for this is that auditors in the big five category are deemed more credible than others, especially in an environment in which business practice is surrounded by corruption and collusion involving a number of players, including external auditors. A statement by the Director of Administration Services on 8 September 2004 signals such an appointment:

> I think collusion between external auditors and clients might occur. We might not be able to avoid such a possibility because this has occurred in our society. This is the reason why *Bintang* always appoints the big five firms. We believe that the big five firms are more credible than other audit firms. In fact, the big five firms are more accountable. (My translation.)

It is also mentioned by people of *Bintang* that external auditors are effective in performing their roles because they understand well the insurance business. Consequently, *Bintang* always appoints the external auditors from the big five firms, who have experience in the insurance industry and set a reasonable fee. In this regard, the Director of Administration Services on 8 September 2004 claimed that:

> The second criteria, the auditing fee, must be competitive and reasonable. Third, the auditor must show consistency in auditing. This means that the audit firm must have experience in auditing insurance companies. Without this experience, it is useless because we have to teach the auditor first. (My translation.)

Similarly, the head of the Internal Audit Unit highlighted on 9 September 2004 that:

> We usually appoint the big five firms. However, after Andersen was involved in the Enron case, we chose an external auditor from the big four firms, such as KPMG, Delloitte, Ernst & Young, and Price Waterhouse. We also consider the audit fee...However, we always employ an external auditor who is very familiar with the insurance business. (My translation.)

Setting such criteria is consistent with arguments by Knapp (1991) and Carcello, et al. (2002). Knapp (1991) posited that the reason the audit committee appoints a reputable auditor is because such an auditor is more likely to disclose discovered errors. Moreover, Carcello, et al. (2002) suggested that a company hires better auditors because they will be more effective in influencing management with regard to financial reporting practice.

Such criteria for the appointment of an auditor have resulted in the fact that an external auditor is powerful in performing its role in *Bintang*. Indeed, the external auditor has greatly influenced the quality of financial reporting. The following narratives by organisational members of *Bintang* describe the extent to which an external auditor is effective in ensuring the quality of financial reporting:

> As far as I know an external auditor is involved in designing the style [of financial statements]. Before a final draft of financial statements is signed, the auditor reviews the reports and sometimes we have a conflict with the auditor, for example, about the use of a certain terminology of information being disclosed. We usually overcome this conflict by making a compromise. (My translation from a statement by the Director of Financial Services on 24 August 2004.)

> I believe that the [external] auditor significantly influences the fairness of financial reports. The auditor always verifies whether *Bintang* complies with regulations and accounting standards. The auditor is also powerful in influencing the Board of Directors to revise any mistakes in preparing financial reports. (My translation from a statement by Mr C in the Accounting Division on 7 September 2004.)

> …the external auditor provides a significant contribution to the quality of financial reporting. As financial statements of insurance companies are regulated by *Bapepam* and the Minister of Finance, it is the role of the auditor to judge whether our company complies with the regulations. (My translation from a statement by the Directors of Administration Services on 8 September 2004.)

> I think an external auditor has the ability to enhance the quality of financial statements…Before we publish annual reports, the external auditor invites the Board of Directors, the Audit Committee and internal auditors to attend a meeting to discuss the results of auditing. Here, the external auditor demands that we complete or disclose certain information to comply with any regulations. (My translation from a statement by the Head of the Internal Audit Unit on 9 September 2004.)

The above statements can be interpreted as meaning that the external auditor has exercised power they have to ensure the quality of financial statements of *Bintang*. By using their expertise and position in a society, the auditor develops power and executes it as a device to influence employees of *Bintang* to be committed to quality financial reporting practice.

#### 8.3.3.4 Internal auditor

The role of the internal auditor is another important facet of a corporate governance mechanism dealing with the assurance of quality financial reporting. Indeed, internal auditors ensure that management teams govern companies ethically and effectively and evaluate and improve financial reporting practice.

The involvement of internal auditors in daily activities concerning operational and financial reporting systems and internal control structures enable the internal auditor to perform thorough and timely assessment of high-risk aspects of the financial reporting process (Rezaee 2002). This role can also be seen from the definition issued by the Institute of Internal Auditors (n.d, p. 1), which sees an internal auditor as:

> …an independent, objective assurance and consulting activity designed to add value and improve an organization's operations…bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, internal control, and governance processes.

In *Bintang*, internal auditors have performed their jobs very well. Organisational members of *Bintang* recognise the importance of internal auditors in shaping financial reporting quality and reviewing the implementation of company's policies. For example, the head of the Internal Audit Unit claimed on 9 September 2004 that:

> As an internal auditor we are responsible for reviewing internal policies, doing a compliance test, assuring an internal control system and reviewing financial reports of branch offices....I also believe that internal auditors contribute to quality financial reporting practice. We act as a second opinion in regard to financial reports prepared by branch offices. If a branch office makes a mistake in the reports, the head office will also include such a mistake in the financial reports. Thus, it is the responsibility of the Internal Audit Unit to detect any mistakes or fraud and to ask those who make a mistake to explain and fix it. So we have made a great contribution to the quality of financial reporting. (My translation.)

Mr C in the Accounting Division supported what the Head of the Internal Audit Unit claimed about the contribution of internal auditors in ensuring quality financial reporting. He believed on 7 September 2004 that:

> ...the internal auditor plays a vital role in determining the fairness of the financial report. At least twice a year internal auditors audit branch offices *(My translation.)*.

This view is echoed by the Director of Administration Services, who was the Chairman of the Audit Committee and worked closely with the internal auditors. He pointed out on 8 September 2004 that:

> …as far as I know the internal auditor has been able to ensure the fairness of data/numbers contained in financial reports. (My translation.)

The Director of Financial Services also expressed a similar concern regarding the role of internal auditors in *Bintang*. He affirmed on 24 August 2004 that:

> The current internal auditors are very good. I am very satisfied with their competence and performance. They are new employees and hold certificates of internal auditing. Their positions in this company are as working partners. They are not like previous internal auditors who behaved like "Tango" in a cowboy film: "I will gun you down if you come out" (My translation.)

The above views insinuate that the involvement of internal auditors in daily activities place them in the best position to oversee continuously the company's internal control structure and financial reporting practice. To quote Rezaee (2002), the appropriate position of internal auditors in an organisational structure and their knowledge and familiarity with managerial policies and operating procedures, enable them to identify and assess red flags signalling the possibility of a financial statement fraud. Internal auditors provide assurance on the quality of financial and non-financial measures (Melville 2003). With their knowledge and expertise, internal auditors of *Bintang* have power to influence financial reporting practice. Nevertheless, it should be noted that the effectiveness of internal auditors to prevent and detect the possibilities of financial statement fraud also depends on their organisational status and reporting mechanism.

Even though the case of *Bintang* provides evidence of the effectiveness of internal auditors in determining the quality of financial reporting, *Bintang* faced a problematic issue in regard to the position of internal auditors in its organisational structure. This can be seen from a discussion in the Audit Committee meeting held on 3 August 2004. In this meeting, it was proposed that in the organisational structure, the Internal Audit Unit was under the President of the Board of Directors. This proposal was debated by members of the Audit Committee and the Board of Directors. For example, a member of the Audit Committee disputed that:

> …if the position of the Internal Audit Unit is under the President of the Board of Directors, the role of internal auditors is not clear and no longer independent. They should be independent. (My translation from the Minutes of Meeting—the Audit Committee KA 08.04-3 August 2004.)

However, the President of the Board of Directors claimed that under the current condition of *Bintang,* it is difficult for her if the Internal Audit Unit is not under her supervision. This claim can be seen from her statement in an interview conducted on 16 September 2004:

> We debated the role of internal auditors in this company. The Audit Committee argues that internal auditors should be under the Audit Committee. But I disagree with this because I need internal auditors to help me control and review the work of divisions and branch offices. It is impossible for me to do all these jobs without a support from internal auditors. (My translation.)

As the management and leadership style of *Bintang* is characterised by Javanese culture, which stresses *musyawarah* (mutual deliberation) and *mufakat* (the common unanimous decision), a decision regarding the position of the Internal Audit Unit was finally made based on a compromise. At a meeting (3 August 2004), the Chairman of the Audit Committee decided that the Internal

Audit Unit would be temporarily under the President of the Board of Directors, but the President must report to the Audit Committee whenever she assigns a job to the internal auditors. In the meeting the chairman said:

> …the reason for the current position of internal auditors is that the Internal Audit Unit has not been strong enough and the audit committee has limited time to supervise the auditors. If the Internal Audit Unit is strong enough, it will be under the supervision of the audit committee. (My translation from the Minutes of Meeting—the Audit Committee KA 08.04-3 August 2004.)

This decision is acquiesced to by the Board of Directors. For example, the President of the Board of Directors said on 16 September 2004:

> ...finally, we compromised that both the Board of Directors and the Audit Committee have the internal auditor. Any time I assign a job to the internal auditors I have to report it to the Audit Committee. (My translation.)

The Directors of Financial Services supported such a view and believed that such a position would still enable the internal auditors to perform their roles effectively. On 24 August 2004, he highlighted his views as follows:

> The current internal auditors have performed their roles effectively and report their findings to the Audit Committee and the President of the Board of Directors. In the latest meeting with the Board of Commissioners, we discussed the possibility of the Internal Audit Unit under the Audit Committee. But at the time the Board of Commissioners did not agree with this because the Board of Commissioners was not sure that the Audit Committee was able to monitor directly the work of internal auditors. (My translation.)

Similarly, the head of the Internal Audit Unit claimed that the current position of internal auditors in the organisational structure was not a major problem for him and his subordinates. Indeed, on 9 September 2004 he argued that:

> ...ideally, internal auditors should not be under the President of the Board of Directors. Instead, they should report and be responsible to the Audit Committee. However, we do not find this ideal mechanism in Indonesia at the present time. *Bintang* just established an Internal Auditor Charter a couple of weeks ago. Regarding our current situation, it is impossible for *Bintang* to have an ideal mechanism. (My translation.)

The Head of the Internal Audit Unit continued to justify that although his position in *Bintang* looks problematic, he does not lack independence. This is because for him, independence does not come from a structural position, but from morality of an individual performing their role. He clarified on 9 September 2004 that:

> Even though I am responsible to the President of the Board of Directors, I have a direct access to the Audit Committee. This is because I have a regular meeting [every month] with the Audit Committee. I have moral bravery in performing my job because it is the Audit Committee who has a right to hire or to fire an internal auditor. I am not afraid to criticise divisions or branch offices, if they have weaknesses or makes a mistake. (My translation.).

This statement is also boosted by Mr C, who was the former external auditor of *Bintang* and worked closely with the internal auditor. Mr C, who is currently employed by *Bintang*, asserted on 7 September 2004 that:

> ...the internal auditors are very independent even though their positions are structurally under the President of the Board of Directors. I believe that the internal auditor cannot be influenced by the Board of Directors. His independence largely depends on his personality and background. I am sure that if the internal auditors want to quit *Bintang* now, it is not a problem and he will quit. I have a close relationship with the Head of the Internal Audit Unit. He is independent because of his professionalism not his hierarchical position. (My translation.)

The above statements indicate that the position of internal auditors is not a major problem for the internal auditors. Indeed, such a position still enables internal auditors to perform their roles independently and effectively. Besides morality as discussed above, appropriate work plans and ethical characters of internal auditors are the key success factors of the effectiveness of internal auditors. In this regard, the head of the Internal Audit Unit claimed on 9 September 2004 that:

> Internal auditors can work effectively because we have a work plan. We also have dedicated people in this unit [the Internal Audit Unit]. They hold certificates of internal auditing...(My translation.)

The effectiveness of internal auditors is also clarified by the former external auditor of *Bintang* (Mr C). On 7 September 2004, he justified the effectiveness of internal auditors as follows:

> I audited a number of companies and I can compare one with another. I have never found internal auditors as effective as the internal auditors of *Bintang*. What I mean here is that the internal auditors of *Bintang* have performed their job rigorously and are committed to improving skills by taking certifications in internal auditing and by attending internal audit training...I also witnessed that...there was open communication between internal auditors and an external auditor. I believe that internal auditors have a systematic work plan. (My translation.)

The above narratives illustrate that internal auditors have performed their roles successfully in *Bintang*. They recognise the power they have and are able to exercise that power to perform their roles, especially in ensuring the quality of financial reporting. To quote Greiner and Schein (1988), internal auditors of *Bintang* exercise their power in a meeting by using data (findings) to convince other employees. A number of meetings held by both the Board of Commissioners and the Audit Committee showed that they mostly discussed crucial issues based on findings by the internal auditors.

The case of *Bintang* signals that an effective corporate governance mechanism can be accomplished when employees involved in the mechanism recognise their presence in the company and have symmetric power to play their roles. Individuals, as Pfeffer (1981, p. 181) explained, have a need to develop an understanding of their organisational environments. Such understanding must be meaningful and makes sense in order to explain actions, why they are performed, how they make sense, what they relate to and how they fit into the organisation's rationale.

In order to do so, referring to the works by Pfeffer and Salancik (1978) and Pfeffer (1981; 1992), actors must have power to interpret, translate, implement and operationalise the discourses of transparency, public accountability and ethical business. This means that in a social relationship, power can be distributed symmetrically among individuals if there is a strong sense of public accountability and ethical conduct among them.

Tetlock (1985b; 1992) claims that accountability is closely associated with ethical behaviour because accountability denotes the perception of defending or justifying one's conduct to an audience that has reward or sanction authority, and where rewards and sanctions are perceived to be conditional on others' evaluation of such conduct. Because a social relationship mutually connects with characteristics of the individual, issues and organisations in influencing unethical behaviour (Brass, et al. 1998), it is believed that the possibility of unethical behaviour between two individuals will be reduced if "their relationship is strong, multiplex and symmetric in terms of power" (Beu, et al. 2003, p. 89)[59].

In general, it can be inferred that the case of *Bintang* is congruent with claims by Finstad (1993) and Jepperson (1991), that in response to institutional pressures, political actors or leaders interpret the pressures and mobilise power in their organisations to control or influence their organisational responses and to cope with the outcomes of the pressures. By so doing, targeted objectives of the organisation can be reached without any significant resistance from other members of the organisations.

The next section will discuss how powerful actors in *Bintang* mobilise power to drive its organisational members to be committed to ethical and transparent business practice, including financial reporting practice.

## 8.4 POWER MOBILISATION AND FINANCIAL REPORTING

The above discussion showed that all actors involved in an organisation behave to influence each other. Salancik and Pfeffer (1977) argue that organisations are typically run by a dominant coalition of individuals or group that accrue power on the basis of being able to cope with critical organisation problems. Accordingly, individuals will look for and develop sources of power to gain some benefits, either for themselves or for a company.

However, as discussed in Chapter Three, holding power is not the main way to influence individual behaviour. Indeed, power must be exercised. For

[59] According to Beu, et al. (2003), strong relationship is based on cooperation, trust, intimacy, empathy, reciprocity and emotional intensity; whereas multiplex relationship includes both friends and business associates.

Mintzberg (1983), to influence others an individual needs some source or basis of power, and the expenditure of energy in a politically skilful way when necessary. Pettigrew and McNulty (1995) also illustrate how features of context, structure, power sources and will and skills are combined to deliver intended effects of the exercise of power. Hardy (1996) offers an excellent discussion of how different power can be mobilised to achieve intended outcomes.

In reference to financial reporting practice, an individual who holds power must get involved in organisational activities and be able to mobilise power to achieve an intended outcome. Yukl (1989) highlights that there are three possible outcomes of the exercise of power: commitment, compliance and resistance.

Commitment and compliance are more desirable outcomes than conflicts or resistance. If conflicts or resistance are likely to occur, Hardy (1996) suggests that they can be overcome by mobilising power. This is because in a social relationship, as Hardy (1996) argues, the abilities of a leader to influence organisational members are to some extent determined by the perception of the members of the abilities of a leader in mobilising power.

By mobilising power, powerful actors can construct an organisational reality that drives other actors to be committed to quality financial reporting practice. In a boardroom, for example, Pettigrew and McNulty (1995) show that members of a part-time board may mobilise and activate various power sources as they seek to obtain outcomes important to them. Furthermore, they (1995, p. 204) argue that "mobilization and skilful use of power may change the rules of the game and provide a new context for subsequent attempts". Good leadership is also needed for the purpose of mobilising power. Leadership can come from any individuals in the organisation, who have charisma, expertise and abilities in influencing the behaviour of other individuals.

For Hardy (1996) power is multidimensional. She classifies power into four dimensions: power of resources, power of decision making, power of meaning and power of systems. Power mobilisation, according to Hardy (1996, p. 10) "involves a coordinated approach that encompasses all three dimensions to influence actions, awareness and values, and avoid both inertia and confusion". Based on Hardy's (1996) concepts of power, the following section describes how powerful actors in *Bintang* mobilise power to influence other organisational members to be committed to quality financial reporting practice.

### 8.4.1. Power Mobilisation by the Board of Directors (CEO)

The board of directors plays an important role in the financial reporting process and is responsible for fair presentation of financial statements in accordance with established criteria, such as accounting standards and other regulations. The integrity and quality of financial reporting show management's commitment in preparing and publishing relevant, reliable and useful information about a company's financial position, results of operations, and cash flows (Rezaee 2002).

To build commitment in quality financial reporting, the board of directors must be able to mobilise power. They might gain power from a structural position, expertise and prestige, and use a number of strategies to exercise power. In

*Bintang*, the Board of Directors has been successful in mobilising power to direct all players to commit to quality financial reporting practice.

#### 8.4.1.1 Power over Resources and Systems

With respect to power over resources and power over systems, the *Bintang* Board of Directors has determined a strategy to bond all individuals within it by institutionalising rules to commit them to transparent and ethical business practice. The use of *Kesepakatan Kerja Bersama* (Mutual Working Agreement) as a code of conduct, and *Sismajaprima* as a procedure of individual performance assessment, and the formation of ethical culture, as discussed in Chapter Five and Seven, are examples of how the Board of Directors mobilise power over resources and systems to accomplish targeted outcomes (such as quality financial reporting practice). As a result, most people are committed to ethical and transparent business, including the practice of financial reporting.

It was discussed in Chapter Seven that through the implementation of *Kesepakatan Kerja Bersama* and *Sismajaprima,* all people of *Bintang* are directed to a condition of either obeying the rules or leaving the company. For example, statements by Mr A (on 3 September 2004) and Mr G (on 15 September 2004) showed that to continue working at *Bintang,* organisational members must obey all rules and accept the organisational culture of *Bintang*. Otherwise, they will individually leave the company or be fired.

To quote Greiner and Schein (1988, p. 47), in mobilising power, the Board of Directors has employed the strategy of "going around the formal system" by institutionalising formal organisational rules. Furthermore, what the Board of Directors has undertaken shows that compliance to obey organisational rules and other regulations can be mobilised through the exercise of reward power and legitimate/position power (Yukl 1989).

#### 8.4.1.1 Power over Meanings and Decision Making

The Board of Directors has also been able to mobilise power over meanings and decision making. The establishment of a number of executive committees, as described in Chapter Five, can be seen as a strategy set by the Board to manipulate symbols. By involving key organisational members from different divisions or units in the committees, employees perceive that their roles in *Bintang* are seen as important and appreciated by the Board.

In addition, the committees can be seen as symbols of sharing power because all crucial decisions are made based on teamwork (Northouse 2004) through *musyawarah* and *mufakat* (consensus not confrontation). The establishment of executive committees is an attempt to show employees that all crucial decisions are made by a team. Thus, the Board of Directors wants to show to all company individuals that it is not the Board that makes the decisions, but the committees. The committees are perceived as "collective activities that are socially perceived essential by those who share culture" (Hofstede 1987, p. 3). Consequently, organisational members will support the implementation of transparent and ethical business in *Bintang*, including financial reporting practice.

Another example of the mobilisation of power over meaning is the replacement of the name of the Accounting Division, as described in Chapter Five. The previous name of this division was the Division of Accounting and SOP Development. However, as the Head of this division observed, the Division of Accounting and SOP Development implied a wider range of responsibilities, and he asked for a lower position if the company still employed the name. To accommodate his complaints, the Director of Financial Services changed the name to the Division of Accounting. The reason for doing this, as the Directors said on 24 August 2004, is that the Head of the Accounting Division is a dedicated and hard working person.

The Board of Directors, as leaders, made such a change to avoid resistance and conflict that might influence commitment to quality financial reporting practice. This illustrates a view that leadership is a process of managing symbols (Simpson 2004). Simpson (2004, p. 117) asserts that leadership, can be seen as:

> …a process of symbolic management, where the leader manipulates symbols that are meaningful to followers and that make them feel good about themselves. In this respect leadership shares many of the characteristics of emotional intelligence, in that the leader needs to recognise emotions, assimilate and understand emotions and then manage emotions to achieve positive outcomes.

Within the view of Greiner and Schein (1988, p. 47), in mobilising power, the Board of Directors employed a strategy of "using social networks" through alliances or coalitions, and dealt directly with the key decision makers in the committees.

The above descriptions show that the Board of Directors is able to mobilise power over meanings and decision making to overcome the possibilities of resistance in conducting transparent and ethical business that support quality financial reporting. Practice in *Bintang* is in congruence with a view by Rezaee (2002). Rezaee (2002, p. 129) claims that the board of directors (his term was "top management team") are:

> …responsible for developing and executing corporate strategies, safeguarding its financial resources, complying with applicable laws and regulations, achieving operational efficiency and effectiveness, establishing and maintaining an adequate and effective internal control system, and designing and implementing a sound accounting system that provides reliable and high-quality financial reports.

This statement implies that financial reporting quality is the responsibility of management, and accordingly, management is responsible for the prevention and detection of financial statement fraud (Rezaee 2002). On the contrary, the case of *Bintang* refutes views by Finkelstein (1992), Heleblian and Finkelstein (1993) and Roe (1991), claiming that the top management team (the board of directors) have stronger power than other actors because the top management team has enormous influence over decision-making processes.

The reason for such a difference is that the founders have institutionalised an organisational culture that drives all organisational members of *Bintang* to be committed to ethical business practice and shapes a leader to be an exemplary model for subordinates. By doing so, the Board of Directors has no chance to exert power to override other employees' abilities to exercise effectively their monitoring roles, and the Board would feel embarrassed if it abused power.

### 8.4.2 Power Mobilisation by the Board of Commissioners

A previous section discussed how *Bintang*'s Board of Commissioners performs its roles through independent commissioners. Even though the Board of Commissioners is not directly involved in daily activities of *Bintang*, it has successfully mobilised power.

#### 8.4.2.1 Power over Systems and Meaning

Through the Chairman of the Board of Commissioners, who is the charismatic founder of *Bintang*, the Board of Commissioners has mobilised power over systems and meaning by institutionalising the principles of public accountability, conservatism, transparency and ethical conduct in the company. The adoption of the public accountability principle is crucial to build ethical conduct. Willmott (1998) argues that by describing corporate values, codes of conduct invite and require the accountability of organisational members to these values. This means that accountability, as a universal social norm, can be seen as leading to internal pressures to comply (Tetlock 1985b; 1992).

Consequently, employees are likely to act and make ethical decisions based on explicit knowledge of the values of those to whom they are accountable (Brief, et al. 1991). Through the use of very close relationships (*rukun*) and increasing the understanding of normatively acceptable behaviour, as Beu, et al. (2003) suggested, accountability should lead to more ethical behaviour. This is because when individuals endeavour to behave ethically, they face an ethical dilemma, either acting according to their own values or complying with the values of their boss or prevailing culture (Brief, et al. 1991).

Considering the above views, it is reasonable to believe that principles such as accountability, transparency and conservatism are well accepted in *Bintang* and have shaped the behaviours of its organisational members, from the Board of Directors to the lowest positions. Indeed, such principles are perceived as part of *Bintang*'s culture. A statement by Mr A, who has worked at *Bintang* more than 25 years signals such acceptance:

> This tradition [conservatism] is a commitment that is strongly maintained by the founders and there is no space for us to break the tradition. It is a very strong belief. We have no power to change the tradition...I believe that all employees understand the value and have implemented the value. Otherwise, they will certainly leave this company. (My translation.)

DiMaggio (1995, p. 13) claims that institutionalisation of such principles reflects "the relative power of organized interests and the actors who mobilize power around them".

Showing ethical conduct to organisational members is another example of how the Board of Commissioners mobilises power over meaning and symbols. By doing this, what is done by commissioners can be seen as a symbolic way to show all organisational members that what commissioners say is what they do. Leadership and the behaviours of commissioners are symbols used to exercise power to influence organisational members of *Bintang*. To quote Hunt and Laing (1997, p. 32), "effective leaders use a variety of behaviours plus oral and written communications to transmit their visions, their differences, and their values" into organisational members.

Similarly, Schein (1996, p. 61) adds that the process of such transformation is performed by "developing his/her [leader's] behaviour as a model that encourage subordinates to identify with them and thereby internalise their beliefs, values, and assumptions". As the beliefs, values and assumptions are perceived to be successful in shaping transparent and ethical business practice, including financial reporting practice, individuals in *Bintang* begin to accept them as taken-for-granted beliefs, and they become unique symbols of the company.

#### 8.4.2.2 Power over Resources and Decision Making

In mobilising power, the Board of Commissioner cannot separate power over resources and power over decision making. These two dimensions of power are mobilised together, especially in monitoring the Board of Directors. In light of Greiner and Schein's (1988, p. 47) views, strategies employed by *Bintang*'s Board of Commissioners in mobilising these dimensions of power are the use of '"social networks" (deal directly with the audit committee), "playing it straight" (using data provided by the audit committee to convince others), and "going around the formal system" (the use of organisational rules).

With such strategies, the Board of Commissioners has been successful in preventing the Board of Directors from getting involved in fraud and irregularities in financial reporting practice. In fact, the Board of Commissioners, through the general meeting of shareholders, has a right to set directors' remuneration, hire and fire directors and appoint external auditors.

An example of how the Board of Commissioners mobilises power over resources and decision making can be seen in the 2004 Management Annual Meeting held on 4 February 2004. Based on findings by the internal auditors, there was a tendency of some employees in branch offices to be involved in fraud, such as corruption and data manipulation. In this regard, the Chairman of the Board of Commissioners argued that:

> ...a number of employees deliberately use authorities to increase their own benefits...the Board of Directors must take action to clean *Bintang* from such unethical behaviour. *Bintang* is not a private company that can be managed for self-interests. We should not think that everything is negotiable. Management must be responsible for this. If shareholders complain, they will blame not only the Board of Directors but also the Board of Commissioners. (My translation.)

Another commissioner said:

> We have conducted ethical business, but the company's performance was unfavourable...We might think that such negative performance was mainly because of misfortune. But this was a wrong conclusion...To improve performance we should be able to separate those with ethical conduct from those with unethical conduct...It is not an easy task, but it is the job of the Board of Directors. (My translation.)

These statements illustrate how the Board of Commissioners mobilises power over resources and decision making to influence the Board of Directors and employees to be committed to ethical and transparent business practice, including financial reporting practice. These statements signify that the abilities of the Board of Directors in resolving such a problem can be used by the commissioners as an indicator of assessing the performance of the Board of Directors.

Another example of power mobilisation over resources and decision making is seen in how the Board of Commissioners used a strategy to force the Board of Directors to comply with regulations on financial reporting. At a meeting held by the Board of Commissioners on 18 March 2003, the Board of Commissioners exercised its power through the use of empirical findings by the audit committees.

One of the findings on 4 February 2003 was that the Board of Directors received a letter from the DGFI (the Ministry of Finance) warning that the level of solvency of *Bintang* did not fulfil the level required by the regulation (Decree No. 482/KMK.017/1999). At this meeting, the Board of Commissioners asked the Board of Directors to solve this problem. The Board of Commissioners also approved the final draft of audited financial statements and approved the appointment of the audit firm "Prasetio, Sarwoko & Sarwoko" as the external auditor of *Bintang* for the next year. Moreover, the Commissioners also discussed a candidate for the job of director, who would be appointed in the annual general meeting of shareholders on July 2003.

These examples show that through the process of meetings, the Board of Commissioners is able to mobilise power to shape a reality that what the Board of Commissioners does is legitimate and rational. Consequently, there is no room for the Board of Directors to disobey regulations or to appoint an external auditor that the Board of Directors likes for their vested interests. By mobilising power over resources and decision making, it can be seen that the Board of Commissioners is able to set a condition that makes the Board of Directors dependent on the Board of Commissioners.

### 8.4.3 Power Mobilisation by the Audit Committee and Internal Auditors

The role of the Audit Committee of *Bintang* cannot be detached from the role of internal auditors. The Audit Committee and internal auditors work together to review the implementation of *Bintang*'s policies and to create quality financial reporting practice. Thus, both the Audit Committee and internal auditor perform their roles together in mobilising power. Cohen, et al. (2004, p. 125) argue that the effectiveness of an audit committee is strengthened when it is able to allocate the resources of internal audit staff to gather important information on "issues within the company of concern such as the strength of internal controls and quality of accounting policies".

#### 8.4.3.1 Power over Resources and Meaning

The role of internal auditors is to review the implementation of company policies and to audit financial statements of branch offices. In doing this job, internal auditors use company values, symbols and rules as a legitimate means of influencing the organisational members of *Bintang*, especially in branch offices, to be committed to transparent and ethical business practice. Thus, internal auditors mobilise power by manipulating symbols and rules so as to convince others that what internal auditors do is legitimate and rational (Bradsaw 1998; Hardy 1996).

Company policies and operating procedures are examples of organisational rules used by the internal auditor to influence others. Through these policies and procedures, internal auditors can determine whether organisational members comply with the organisational rules. Sisaye (1997) argues that power control issues in organisations are associated with rules, procedures and practices, as well as formal and less formal relations. Consequently, any findings by internal auditors apparently force *Bintang*'s organisational members to commit to ethical and transparent business practice because based on the findings, internal auditors can place them in unfavourable positions. Indeed, findings by internal auditors can be used by the Board of Directors to either fire or promote employees.

Findings by internal auditors are also used by the Audit Committee to influence the Board of Directors to overcome any problems that exist in *Bintang*. The use of formal reports sent to the Board of Commissioners can be seen as a symbolic action to convince the Board of Directors that actions performed by the Audit Committee, as Hardy (1996) suggested, are rational and legitimate. Consequently, there is no choice for the Board of Directors except responding to any requests by the Audit Committee.

Bourgeois (1991) and Vecchio (1997) claim that organisational members can be forced to obey what a leader requests because the leader controls key organisational resources (such information, skills and monetary reward). Within the framework of Greiner and Schein (1988, p.47), the above description shows that audit committee and internal auditors are able to mobilise power over resources and meanings by employing a strategy of "going around the formal rules" (using company procedures and rules) and "developing a social network" (alliance and coalition between the audit committee and internal auditor).

#### 8.4.3.2 Power over Decision Making

In mobilising power over decision making, the Audit Committee and internal auditors have the authority to arrange a meeting and to force the Board of Directors of *Bintang* to attend it meeting. The Audit Committee has also authority to ask the appointed external auditor to be present at the meeting. During this process, the Audit Committee can employ any findings from the audit processes by both internal auditors and external auditors to influence the Board of Directors. Gendron and Bedard (2004) argue that the social construction of the effectiveness of the audit committee is determined by "the ability of the audit committee to ask questions, have private meetings with external auditors and through ceremonial and substantive components of the meeting" (cited by Cohen et al. 2004, p. 96).

A number of meetings held by the Audit Committee showed its ability to mobilise power over decision making to influence the Board of Directors. An example of this is a meeting held by the Audit Committee on 15 March 2004, where it discussed findings concerning a problem with financial reporting disclosure and the possibility of fraud in *Bintang*. By involving the appointed external auditor and internal auditors, the Audit Committee was able to force the Board of Directors to take necessary actions and disclose necessary information in annual reports. In this meeting the Audit Committee asked the external auditor to explain findings concerning the claim payable account. The external auditor explained his findings as follows:

> A claim by PT. Knitting and Garment Industry since 1994 had not been settled. According to a confirmation I received from a lawyer, *Bintang* had been waiting for a final decision from the Supreme Court. I asked management to explain this case because *Bintang* had spent a lot of money on it. (My translation form the Minutes of Meeting, the Audit Committee KA 04/04 15 March 2004.)

In response to the case, the Director of Financial Services argued that:

> …actually, this case was over and we won it. However, the company had appealed to the Supreme Court to review the case. Unfortunately, until now [15 March 2004], we had no information of the progress of this case. *Bintang* could do nothing, as this case had been taken over by the insurance leaders [the Indonesian Insurance Committee]. (My translation form the Minutes of Meeting, the Audit Committee KA 04/04 15 March 2004)

Based on this information, the external auditor asked the Board of Directors to reclassify the payable account regarding the case, from "claim payable" into "other liability".

The above example shows how the Audit Committee mobilises power over decision making by involving an external auditor to force the Board of Directors to explain an existing problem in *Bintang* for the purpose of disclosing better information in annual reports. Indeed, as DeZoort (1998) suggested, an audit committee with greater experience is able to make control evaluations more in line with the external auditors. In addition, DeZoort and Salterio (2001) concluded that knowledgeable audit committee is likely to support the external auditor in a dispute with management. This means that with expert power, an audit committee can mobilise power over decision making.

An audit committee can mobilise power over decision making because the committee has knowledge, expertise and information that enables it to frame the agenda of meetings. Indeed, Kahneman and Tversky (2000) contend that individuals' decisions depend critically on how their options are framed. In regard to the case of *Bintang*, the above example shows that the Audit Committee sets the agenda for a meeting and hence controls how issues are framed to direct discussions with external auditors and the Board of Directors. This is what Greiner and Schein (1988, p. 47) refer to a strategy of "playing it straight" by using data/findings to convince and influence others and focusing on the needs of a targeted audience through framing the agenda of meetings.

### 8.4.4 Power Mobilisation by External Auditors

Power mobilisation can also be exercised by an external auditor, even though the auditor is an external party in the corporate governance mechanism. However, external auditors can only mobilise power if they are independent and have professional expertise in regard to the types of business they will audit. External auditors can mobilise power over resources and power over decision making to influence a board of directors and other organisational members.

#### 8.4.4.1 Power over Resources

Power over resources is the dimension of power that an external auditor can mobilise. The work of external auditors is seen as a crucial determinant of quality financial reporting practice. In *Bintang*, the role of external auditors in ensuring quality financial reporting is not necessarily debated. Through mobilisation of power over resources, the external auditor of *Bintang* is able to prevent fraud and irregularities.

With their independent status and legitimacy as a party that determines fairness of financial statements, external auditors can make the Board of Directors dependent on their jobs. Such dependency tends to increase if the Board of Directors sees financial statements as an important medium of building a company image as experienced by *Bintang*.

An example of how *Bintang* depends on the work of the external auditor can be seen from a meeting involving the Audit Committee and an external auditor held on 10 October 2002. At this meeting, the Board of Directors and the Audit Committee asked the external auditor to start auditing activities on November 2002 and finish before March 2003. This is because *Bintang* wanted to publish its annual reports on time to maintain the company's image as the winner of the 2001 annual report award. This request by the Board of Directors shows explicitly that *Bintang*'s image is dependent on the external auditor. Because a company image reflects the performance of the Board of Directors, this Board will rely on the external auditors. This example infers that the external auditor is able to mobilise power over resources to ensure that organisational members of *Bintang* are involved in ethical and transparent business.

#### 8.4.4.2 Power over Decision-Making

The effectiveness of external auditors in performing their roles in financial reporting practice of *Bintang* can be seen from their abilities in mobilising power over decision making. Through intensive meetings with the Audit Committee and the Board of Directors, the external auditors can manipulate findings during auditing processes to shape the financial reporting practice of *Bintang*.

An example of the ability of external auditors in mobilising power over decision making is seen in a meeting held on 23 December 2003. This meeting was attended by the Audit Committee, internal auditors and the Board of Directors. The external auditor explained to the audience that there were a number of weaknesses in the internal control system, operating procedures and financial administration. For external auditors, such weaknesses could lead to fraud and irregularities.

In response to the auditors, the Audit Committee asked the internal auditors to prepare flowcharts of operating procedures to be discussed with the external auditors, and asked the Director of Financial Services to implement a better standard operating procedure. Furthermore, based on the findings, the Audit Committee required the Board of Directors to make a separate account for "premium collection" and "operating expenses" to prevent any possible fraud by branch offices. At the meeting, a member of the Audit Committee suggested that the Director of Financial Services implement the following policies[60]:

1. the use of separated accounts for "premium collection" and "operating expenses"
2. branch offices are no longer allowed to use "premium collection account".

The Director of Financial Services agreed with the suggestion and discussed it with the Division of Finance for its implementation.

[60] Sources: the Minutes of Meeting, the Audit Committee of *Bintang* KA 12/03, 23 December 2003

At the meeting, the external auditor also demanded the Board of Directors to implement the "2010 System" immediately. The auditor suggested that the "2010 System" should be able to ensure the accuracy of data for creating transparent financial reporting. The Board of Directors also agreed with this demand, although the Director of Financial Services said that the "2010 System" had not been implemented yet because infrastructure and human resources of *Bintang* were not ready. Based on suggestions by the external auditors, the audit committee asked the Director of Financial Services to discuss the "2010 System" with the Director of Administration Services because the system should be implemented in the forthcoming year.

The above examples show how external auditors are able to influence other *Bintang* employees through mobilisation of power over resources and over decision making. The external auditor can mobilise power effectively because they are independent and understand well financial reporting practice of the insurance company. In addition, the external auditors are not involved in any conflicts of interest with *Bintang*, and their engagement in *Bintang* is rotated regularly by the Board of Commissioners through a mechanism undertaken in the general meeting of shareholders.

**8.5 CONCLUSION**

This chapter discussed powerful actors behind the practice of quality financial reporting in *Bintang*. Through a discussion of power and leadership within the Javanese context, it can be seen that leadership plays a crucial rule in shaping the social construction of financial reporting practice in *Bintang*. By placing themselves as a *Bapak*-father in *Bintang*, and seeing the company as a big family, the leader has successfully guided organisational members in running ethical business activities, including financial reporting practice. The leaders act not only as managers, but also as teachers and problem solvers. They have successfully behaved as exemplary models for their subordinates, exercised power through soft commands and avoided direct confrontations. What *Bintang* showed implies that its leadership style reflects the Javanese view on leadership, which is characterised by the image of leaders that are an exemplary model for their subordinates (*ing ngarso sung tulodo*), are able to empower subordinates (*ing madyo mangun karso*) and have a sense of responsibility to their subordinates (*tut wuri handayani*).

Moreover, besides leadership style, the corporate governance mechanism in *Bintang* has been successful in shaping quality financial reporting practice because there is a balance of power distribution among actors involved in the mechanism. Interestingly, considering their power bases, power bases of other players and strategies of exercising power, most of the actors have mobilised power through the use of strategy of alliance and coalition to influence other actors. In doing so, the actors will involve other players when they want to convince others regarding certain issues. For example, the Audit Committee will engage either internal auditors or external auditors to influence the Board of Directors regarding financial reporting practice. In a similar way, in spite of directly dealing with the Board of Directors, external auditors always involve the

Audit Committee in discussing their findings in regard to internal control weaknesses or procedures and other financial reporting issues. This signifies that collectivism and consensus, two important values in Javanese culture, as described in Chapter Seven and this chapter, greatly determine decisions made by actors concerning financial reporting of *Bintang*.

Hence, financial reporting practice in *Bintang* is a dynamic process involving a number of actors and institutions that are strongly influenced by the cultural environment. Indeed, the financial reporting practice of *Bintang* is a reflection of the Javanese view on an ethical social relationship.

# CHAPTER NINE
# CONCLUDING REMARKS

## 9.1 INTRODUCTION

This chapter describes a final note concerning conclusions on the use of theory and on research questions and limitations of this study. The case of *Bintang* provides a useful lesson regarding financial reporting practice in a unique company surrounded by a unique culture, Javanese culture.

The first section of this chapter will draw some conclusions on the use of institutional theory and power mobilisation as a theoretical lens of understanding financial reporting practice in *Bintang*. This will be followed by conclusions on research problems as described in Chapter One. Next, this chapter will point out the contribution of the study to the knowledge of accounting. Finally, limitations of the study conclude this chapter.

## 9.2 CONCLUSIONS ON THE USE OF MULTIPLE THEORIES

It is claimed in this study that ontologically financial reporting practice is a socially constructed reality. Financial reporting, in the sense of such a reality, is seen as an institutional and political practice involving institutions and powerful actors. To understand such a practice, we need to include an understanding of institutional factors and actors' behaviour, because such factors and behaviour can construct a reality of financial reporting practice. As such, as discussed in Chapter Three, institutional theory provides a useful framework for understanding the dynamics of financial reporting practice in a unique company. Institutional theory clearly explains why a certain company is committed to quality financial reporting and how the company shapes its internal organisational rules and structures and designs them to be in accordance with socially acceptable beliefs, values and norms, and finally, to socially construct financial reporting practice.

In addition, with the use of power mobilisation as discussed by Hardy (1996) as a complementary theory, both theories are able to explain how actors involved in a corporate governance mechanism exercise and mobilise power over resources, meanings, decision making, and systems to construct financial reporting practice. The ability of organisational players to mobilise power is mainly caused by the fact that there is a balance in power distribution among the actors.

However, as institutions and actors behaviours are influenced by cultural factors, the social construction of financial reporting practice cannot neglect a unique culture in which financial reporting practice takes place. In the case of *Bintang*, a local culture (Javanese culture), as described in Chapter Seven and Eight, greatly influences financial reporting practice. This study claims that financial reporting practice of *Bintang* is a reflection of the Javanese ideas of ethical social relationship.

The use of multiple theories in this study showed evidence of the benefits of using such theories in accounting studies. This can boost sociological studies of accounting and develop the understanding of accounting knowledge and practice within social, political, institutional and cultural contexts. Hence, for the purpose of theoretical use, the results of the literature review bring an array of research endeavours in financial reporting and provide contribution in other studies to several disciplines.

## 9.3 CONCLUSIONS ON RESEARCH PROBLEMS

This research is aimed at answering four research questions. The first two research questions are *why a company is committed to quality financial reporting practice* and *how the company constructs its financial reports to deliver a message to its audience*. By using *Bintang* as a research setting, it was clearly described in Chapter Six that the company is committed to quality financial reporting because such reporting is important for the company to gain legitimacy and to maintain social harmony.

To gain legitimacy and maintain social harmony, the company has designed annual reports as rhetorical stories that provide the true picture of the company's performance and conditions to persuade its constituents. This implies that a rhetorical story does not always use fancy speech to fool an audience. Instead, *Bintang* used a rhetorical story as a medium to provide arguments and logic regarding numbers, information, and pictures contained in annual reports. This is seen by the organisational members of *Bintang* as a useful device to build a company image that shows how *Bintang* complies with all regulations and acts in accordance with socially acceptable beliefs, values and norms.

The third research question is *to what extent external institutional pressures such as regulations/rules force the company to provide information in financial reports*. From the organisational setting of *Bintang*, as discussed in Chapter Seven, it is clear the external environment has put pressure on *Bintang* in preparing financial reports. However, *Bintang* tends to conform to the pressures through coercive, normative and mimetic isomorphism. This is an institutionalised routine that becomes a ritual in *Bintang*.

It is the organisational culture of *Bintang* which determines such conformity. The organisational culture of *Bintang* is built on the bases of public accountability, conservatism and transparency, and is able to shape the behaviour of its actors from the top to lower levels to conduct ethical and transparent business practice. Through the adoption of Javanese culture, organisational members of *Bintang* have behaved ethically so as to maintain social harmony both among organisational members, and between organisational members and its institutional environment.

The case of *Bintang* shows that quality financial reporting practice is strongly influenced by the organisational culture of the company. It is true that regulations affect financial reporting practice. However, compliance with regulations is determined by organisational culture. Thus a company with an ethical culture will more likely be committed to compliance with regulation and to quality financial reporting practice.

The fourth research question is *in what ways do intra-organisational dynamics such as beliefs, values, norms, power and leadership influence* *financial reporting practice.* The case of *Bintang* provides an interesting answer. Taken-for-granted beliefs have shaped the behaviour of *Bintang* organisational members and have driven the company to commit to ethical culture. This ethical culture has also shaped its financial reporting practice.

To build and manage an ethical culture is not an easy task. Nevertheless, with appropriate approaches such as socialisation, monitoring and ethical leadership as an exemplary model for subordinates, ethical culture can be observed and experienced by all organisational members. Through these approaches, ethical culture can be properly institutionalised and is eventually embedded within the company. Beliefs, values, norms, power and leadership are institutionalised, consciously or unconsciously, in *Bintang* through the behaviour of the founders and the Board of Directors by adopting the Javanese ideas on an ethical social relationship. In Chapter Eight, it was discussed that *Bintang,* with its unique leadership style (inspired by Javanese culture) has been able to shape the behaviour of organisational members to commit to quality financial reporting practice. Leaders of *Bintang* have been able to show themselves as exemplary models for their subordinates (*ing ngarso sung tulodo*), as individuals who are able to empower subordinates (*ing madyo mangun karso*) and have a sense of responsibility to their subordinates (*tut wuri handayani*). Consequently, all organisational members behave in ethical ways, conform to all regulations and rules, and focus their organisational life in accordance with the Javanese ideas of an ethical social relationship.

To sum up, regardless of how beliefs, values and norms are institutionalised in *Bintang* to shape individuals' behaviour, to influence the exercise of power and leadership, and then to socially construct financial reporting practice, this study concluded that the financial reporting practice of *Bintang* is a socially dynamic process. It reflects the Javanese ideas on an ethical social relationship. Financial reporting practice in *Bintang* shows that accounting is a social science. It is value laden.

## 9.4 LIMITATION OF THE STUDY

Despite its rich and thick description of the case chosen for this study, it is worthwhile noting a number of limitations. First, the findings of this study are constrained by a single company with a focus on the insurance industry, and are also constrained by a relatively short data collection period (six months), during which there were no new regulations or pressure during data collection that might influence the company. Possibly, a more complete and comprehensive analysis of institutional, political, and cultural change is needed.

Second, even though this study was undertaken by prolonged engagement in the organisational setting, and by using a triangulation approach in collecting data and interpreting research findings, this study may have suffered from a subjective bias, especially in interpreting data or facts. Meanings, symbols, and facts gathered and discussed in this study were translated by the researcher without endorsement by an impartial third party.

Thus, it is possible that meanings, symbols, and facts are misinterpreted unintentionally. Nevertheless, this should not be a crucial problem because no research approach is free from a subjective bias, whatever research paradigm is used. In fact, interpreting and reporting research findings is a matter of rhetoric of how the researcher uses argumentation and logic to persuade an audience.

Thirdly, the field study was performed successfully because of the authority of the President of the Board of Directors. Unfortunately, such authority could lead to a problem. As other ethnographic field studies, this study might be suffered from problems of data credibility. Even though people being interviewed had freedom to express their views and their names were not included in this report, it is possible that they might provide information about the company in favourable tones. This, of course, could result in subjective findings that might not reflect the true description of phenomena being studied. However, because this study was performed using a triangulation approach in collecting data (documentation, participant observation and interview), misleading information could be minimised.

Finally, considering limitations of this study, further studies involving different companies from different industries are needed. In order to examine the consistency of research findings, such studies should be still directed toward answering questions of whether companies with ethical organisational cultures always commit to quality financial reporting practice, does ethical leadership always drive a company to commit to such practice, and does “local culture” influence financial reporting practice of a company?

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## APPENDIX 1 Accounting Standards Issued by KPSAK

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Appendix 1 continued