The Effect of Corporate Governance Mechanism on the Integrity of Financial Statements in Manufacturing Companies in the IDX

Ayu Krisnawati[1], Justita Dura[2]
[1]Institut Teknologi dan Bisnis Asia Malang
Jl Rembuksari No. 1A Malang, (0341) 478877, e-mail: ayukrisnawati1005@gmail.com
[2]Institut Teknologi dan Bisnis Asia Malang
Jl. Rembuksari No. 1A Malang, (0341) 478877, e-mail: justitadura@asia.ac.id

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ABSTRACT

This study aims to evaluate whether the mechanism of corporate governance, which involves institutional ownership, management ownership, independent commissioners and audit committee variables, has a significant impact on the integrity of the financial reports of manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2019-2022. The sampling method uses techniques of non-probability sampling with approach purposive sampling. Based on the research results, it shows that 1) Institutional Ownership has a positive and significant effect on the integrity of financial reports. 2) Managerial ownership has no effect on the integrity of financial reports. 3) Independent Commissioners have a positive and significant influence on the integrity of financial reports. 4) The audit committee has a positive and significant effect on the integrity of financial reports. It is hoped that this research can provide additional strength to integrity in the presentation of financial reports, so that it can support the company's survival.

Keywords: *Corporate Governance, Institutional Ownership, Managerial Ownership, Independent Commissioner, Audit Committee*

1. Introduction

Financial statements are a connecting tool for all parties involved in a business to connect with each other. The presentation of financial statements is very important to show the internal actions of the company, especially management, with regard to available resources. Financial statements provide financial information about the company's operations and performance to external and internal parties (1). According to the provisions in the Financial Accounting Standards (SAK), financial statements are a systematic presentation of the company's operating results and financial condition. Financial statements are considered to be of integrity if they show the company's actual financial transactions (2).

Integrity of financial statements defined *by Statement of Financial Accounting Concept* (SFAC) No. 2 refers to the information contained in the financial statements that are honest,

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reasonable, and unusual. *Conservatism* is a method to evaluate the integrity of financial statements (3). Conservatism in the context of preparing financial statements refers to an attitude of prudence. Caution and vigilance are very important in the preparation of financial statements and auditing considering that financial statements include information about the company's financial condition and performance. Principle *Conservatism* used because by using pessimism to offset managers' optimism, the possibility of excess profits in financial reporting can be reduced (4).

The information characteristic in the concept of conservatism has the potential as an element that can reduce the manipulation of financial statements and improve their integrity. Although financial statements must be maintained with high integrity, making them a difficult task can be a difficult task. Several cases have raised doubts about the integrity of financial statements. Cases that raise concerns about confidence in the authenticity of financial statements (5). Cases in which financial statements were manipulated, namely in the case of PT Waskita Karya Tbk (WSKT) and WIKA since 2016, manipulated the books by hiding many vendor bills. Although both faced financial difficulties, their debt burden increased as a result of the acquisition of such liabilities. WIKA reportedly earned a net profit of Rp. 322 billion in 2020. However, in the following year, it dropped to Rp. 214 billion and in 2022 it slumped to Rp. 12.5 billion. On the other hand, Waskita experienced a decrease in net loss from 9.28 trillion in 2020 to 1.67 trillion in 2022 (https://majalah.tempo.co). This is due to the weak integrity of financial statements and the failure to apply the *Corporate Governance* on the company.

The relationship between the integrity of financial statements and the theory of agency (*agency theory)* and signal theory (*Signaling Theory*) can be explained by the agency theory which highlights the agency conflict between the owner as the principal and the manager as the agent who manages the company. Agency problems arise because both parties are always trying to maximize their respective utilities (6). Implementation *Corporate Governance* and monitoring by external independent parties such as auditors can reduce agency problems and emphasize efforts to improve the integrity of financial statements. This is so that financial statements not only provide benefits for the company, but also provide benefits for external users in the decision-making process.

Standard implementation *Corporate Governance* which has a true impact on the preparation of the company's financial statements (2). This is related to the investor's confidence in the manager that the funds or capital they invest are capable of making a profit, and will not be invested in unprofitable projects. Mechanism *Corporate Governance* has the potential to influence the financial statements made. How companies implement *Corporate Governance* is one of the factors that affect the integrity of financial statements. In this study, institutional ownership, managerial ownership, independent commissioners, and audit committees function as representations of the mechanism *Corporate Governance.*

The integrity of financial statements can be affected by institutional ownership as an additional factor. The value of integrity of financial statements is positively correlated with institutional ownership (3). Increased institutional ownership in an organization can increase oversight of management performance. Institutional shareholding has power as a source of power that can be used to support or hinder management performance related to the integrity of financial statements. Managerial ownership is a way to improve the integrity of financial statements (7). With significant shareholding, managers are more likely to have greater responsibility in managing the business as well as preparing financial statements with honesty and accuracy that can improve the integrity of financial statements.

Independent Commissioners have an effect on the integrity of financial statements. If a company has independent commissioners, the financial statements reported by management tend to have a high level of integrity. This is due to the existence of a supervisory body that protects the rights of parties outside the company's management. The existence of independent commissioners plays a role as a balancer in decision-making, especially the protection of

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minority shareholders and other related parties. The audit committee also has an influence on the integrity of financial statements. The number of members in the audit committee is directly proportional to the possibility of management committing fraud, so that the more members of the audit committee, the less chance of fraud by management (8).

Research (3) indicates that the mechanism of *Corporate Governance* represented by the variable of institutional ownership, independent commissioners, or the audit committee has no impact on the reliability of financial statements. This is different from research (2) Institutional ownership, independent commissioners, and audit committees are factors that affect the integrity of financial statements, but managerial ownership has no effect. The new research is very important because there are inconsistencies from the results of previous studies. Some of the previous studies described have given inconsistent results with regard to the influence of mechanisms *Corporate Governance* on the integrity of financial statements. This indicates that there are limitations or differences of views in the literature. This research can provide an opportunity to improve our understanding of the impact of the relationship between institutional ownership, managerial ownership, independent commissioners and audit committees on the integrity of financial statements (Study on manufacturing companies listed on the IDX in 2019-2022). The purpose of this study is to identify whether the mechanism of *Corporate Governance*, represented by the variables of institutional ownership, managerial ownership, independent commissioners, and audit committees, have a significant influence on the integrity of financial statements in manufacturing companies listed on the Indonesia Stock Exchange.

Main theories about *Corporate Governance* is the theory of agency. According to agency theory, company management is different from owner (9). Based on the concept of agency theory, the management of the company must receive supervision and control in order to ensure that management activities are carried out in full compliance with the applicable rules and regulations. This theory has encouraged the development of various perspectives on *Corporate Governance*. This process results in *Agency Cost,* which according to this theory must be issued to reduce losses caused by non-compliance. *Corporate governance* helps reduce *Agency Cost* caused by a conflict of interest between managers and shareholders. Mechanism *Corporate Governance* can be used to carry out the supervision referred to in agency theory.

The accuracy and reliability of information is reflected in the integrity of financial statements (10). Based on this statement, the integrity of financial statements refers to the presentation of the company's financial data with accuracy, reliability, truthfulness and without any element of misleading information for users regarding the company's economic conditions (11). Integrity of financial statements is the provision and provision of financial statement information with accounting data accurately and transparently (12). Users of financial statements utilize the information to make economic decisions, as the reports reflect the company's financial position, performance, and cash flow. The integrity of financial statements depends on the reliability of their quality. *Reliability* It is an aspect of the quality of information in financial statements that ensures the reliability of the information. Users can rely on this information if the financial statements are proven to be of integrity. On the other hand, if there is an inintegrity and such as *overstatement*, users of financial statements will suffer significant losses.

Agency problems occur due to conflicts of interest or information asymmetry, the company can bear *the cost of the agent.* According to agency theory, conflict of interest and information asymmetry theory can be minimized through the implementation of appropriate supervision mechanisms to regulate the interests of all stakeholders involved in the company. The supervision mechanism is in accordance with the concept of agency which can be found in the corporate governance mechanism.

Corporate governance is a set of regulations that define the relationship between external and internal parties related to the rights and responsibilities of a company, or the system that governs and controls the company (9). Corporate governance is part of the concept that regulates the interaction between management and investors, which causes agency problems. The implementation of corporate governance in a company is one of the elements that affect the integrity of a financial report. Corporate governance is expected to give confidence to investors that their investments will be managed properly. The corporate governance mechanism is proxied with institutional ownership, managerial ownership, independent commissioners, and audit committees.

According to Brigham (2005:528) in research (13) Shareholding by other institutions, such as companies, pension funds, and mutual funds, is referred to as institutional ownership. Shares of institutions or institutions, such as investments, insurance, banks, and others, are called institutional ownership (14). The involvement of institutional investors is expected to act as an effective tool in overseeing managers' decisions. Corporate governance supervision by institutional investors is expected to encourage management to focus more on improving company performance, so as to reduce the risk of fraud including manipulation of financial statements.

A circumstance in which the manager acts as both the owner and the agent at the same time owns shares in the company is called managerial ownership. Managerial ownership has the role of being an agent and has the trust of investors. If the manager owns shares in the company, the manager will act in accordance with the interests of the shareholders because the manager also has a personal interest in it (15).

Independent commissioners are entities in public companies that are responsible for supervising in general and specifically in accordance with the provisions of the articles of association and providing advice to the board of directors (Financial Services Authority (OJK) Regulation Number 33/POJK.04/2014). Companies with independent commissioners tend to produce more accurate financial statements because of the existence of a supervisory body that protects the rights of parties outside the company's management (2). Since they are not related to parties who have interests in the company, independent commissioners are expected to be trusted to protect the company's finances.

The audit committee is a significant element in the framework of good corporate management. Preparing audits, ratifying internal control systems, and resolving disagreements in accounting regulations are the tasks of the audit committee (Hardiningsih, 2010) in the research (16). In financial reporting, the audit committee's job is to supervise and monitor the financial statement audit process, ensuring compliance with applicable standards and policies. The audit committee must also review the financial statements to verify compliance with these standards and policies, as well as ensure consistency with other information known to audit committee members (3).

Supervision is necessary because there is a separation between ownership and management which can cause agency problems (17). Ownership of company shares that are called institutional ownership by institutions or institutions such as insurance companies, banks, investment companies, and others (18). Research (17) stated that institutional ownership has a significant negative effect on the integrity of financial statements. This is inversely proportional to the research (19) and (20) stated that institutional ownership has a positive effect on the integrity of financial statements. Based on the description above, the first hypothesis proposed in this study is as follows:

H1: Institutional ownership affects the integrity of financial statements

One way to improve the integrity of financial statements is to use management ownership (7). With high share ownership, managers have greater responsibility in managing the company and preparing financial statements honestly and accurately, so that financial statements become more integrity. Research (21) stated that managerial ownership has a positive effect

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on the integrity of financial statements. This is inversely proportional to the research (2) stated that managerial ownership had no effect on the integrity of financial statements. Based on the description above, the second hypothesis proposed in this study is as follows:

H2: Managerial ownership affects the integrity of financial statements

Independent commissioners are parts or members of the supervisory board who work outside the company to support decision-making. The appointment and appointment of independent commissioners can be done as part of government rules and regulations, but they cannot guarantee the implementation of good corporate governance. However, the real task of an independent commissioner is to assess the company's overall and overall performance by looking at how management works to build a company that has good corporate governance. Independent commissioners affect the integrity of financial statements, financial statements issued by management tend to have high integrity when the company has an internal institution that supervises and protects the rights of parties outside management (Susiana & Herawaty, 2007) in research (3). Research (22) shows that the results of the independent commissioner are able to moderate the relationship between the influence of audit quality on the integrity of the financial statements, the commissioner. This is inversely proportional to the research (23) and (4) stated that the independent commissioner had no positive effect on the integrity of the financial statements. Based on the description above, the third hypothesis proposed in this study is as follows:

H3 : Independent Commissioners have an effect on the integrity of financial statements

The Indonesia Stock Exchange (IDX) requires listed companies to have an audit committee and independent commissioners as part of good corporate control (3). The Audit Committee has the responsibility to assist the commissioners, ensuring that the organization has implemented corporate governance properly in a business and complies with applicable regulations. The audit committee operates independently in carrying out its duties and obligations. The audit committee is established by the board of commissioners and is tasked with conducting audits related to the implementation of duties by the board of directors in business management including involvement in crucial tasks in the financial reporting system (4). Research (24) stated that the audit committee has a positive effect on the integrity of financial statements. Research (14) The audit committee has a significant influence on the integrity of financial statements if other variables are considered constant. This is reversed with research (7) The audit committee has no effect on the integrity of the financial statements. Based on the description above, the hypothesis proposed is as follows:

H4: Audit committees affect the integrity of financial statements

2. Research Method

The population in this study includes manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the period 2019-2022 with a total population of 171 companies. Sample selection was carried out using *a non-probability sampling* technique with *a purposive sampling* approach. The sample that met the criteria from 2019-2022 was 58 companies, which produced 232 samples. Furthermore, the data obtained will be reprocessed using SPSS version 25.

The integrity of financial statements in this study is included in the dependent variable. Model Beaver and Ryan using *market to book ratio* used in the measurement of the conservatism index on the integrity of financial statements (25):

$$ILKit = \frac{Stock\ Price}{Stock\ Book\ Value}$$

$$\text{Stock Book Value} = \frac{Total\ Equity}{Number\ of\ Share\ Outstanding}$$

The value of shares held by outside entities, including financial institutions and insurance companies, is called institutional ownership (20). Institutional ownership is measured using the formula:

$$KI = \frac{Number\ of\ Institutional\ Investor\ Shareholdings}{Total\ Number\ of\ Shares\ Outstanding} \times 100\%$$

Measuring *the managerial ownership* ratio is one way to find out managerial ownership in a company. This ratio is calculated by the formula:

$$KM = \frac{Number\ of\ Managerial\ Shares}{Total\ Number\ of\ Shares\ Outstanding} \times 100\%$$

In measuring the independence of commissioners, an indicator of the ratio between the number of independent board of commissioners and the total members of the board of commissioners contained in the structure of the company's board of commissioners is used (26)

$$\text{KMI} = \frac{Number\ of\ Commissioners\ from\ outside\ Company}{Total\ Number\ of\ Company\ Commissioners} \times 100\%$$

The audit committee is formed by the board of commissioners with the purpose of overseeing the activities of the board of directors or the company's management. The main goal of the audit committee is to ensure that corporate governance runs well and fairly, as well as to prevent violations of rules that can harm other parties. The number of audit committees is used as a measure of this variable.

KA = Number of Audit Committees

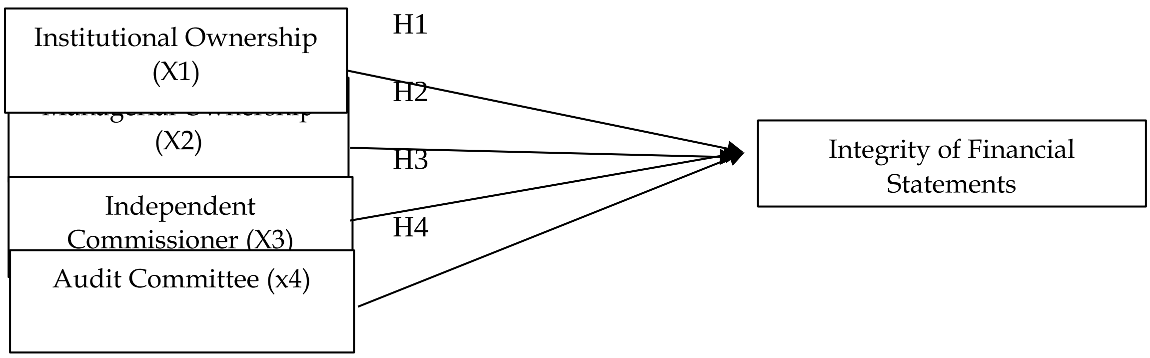

Figure 1. Mindset
Source: Research Data, 2023

3. Results and Analysis

3.1 Normality Test

Normality testing is used to determine whether the residuals of the regression model have a normal distribution. To evaluate the normality of the data distribution, skewness and curtosis ratios are used. The skewness ratio is calculated by dividing the skewness value by the standard error skewness, while the kurtosis ratio is calculated by dividing the kurtosis value by the standard error kurtosis. In general, skewness and kurtosis values are in the range between -2 and +2. It was concluded that the data in this study were normally distributed with a skewness value of -0.78 and curtosis of 1.62 based on data from the normality test table.

3.2 Multicollinearity Test

Multicollinearity is used to assess whether there is a correlation between independent variables in a regression model. If anything, this indicates the presence of multicollinearity. There were no signs of multicollinearity in this study, the tolerance value exceeded 0.10 for the independent variable and the *Variance Inflation Factor* (VIF) value was less than 10.

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3.3 Autocorrelation Test

The next step of the classic assumption test is an autocorrelation test that can be done using *the Durbin Watson* test, provided that if the DW value is between 2 and +2 or <DW < +2 it means that no autocorrelation has occurred.

Table 1. Autocorrelation Test Results

Durbin Watson	**Conclusion**
0.300	No Autocorrelation Occurs

Source: Research data, 2023

From the test results, *a Durbin Watson value* of 0.300 was obtained, which shows that there is no autocorrelation.

3.4 Heterokedasticity Test

Heteroscedasticity testing is carried out to ensure that the regression model to be evaluated shows a constant distribution pattern and does not experience heteroscedasticity. In this study, the glacier test was used to test heteroscedasticity by regressing all independent variables to residual variables. The test was carried out by regressing all independent variables with the Residual variable. Based on the test results, this study has a significant value of >0.05, meaning that heteroscedasticity does not occur.

3.5 Multiple Linear Regression Analysis

Prediction of dependent variable values involves several independent variables in multiple regression analysis. Based on the test results:

$$Y = 117.157 + 0.968X1 + 0.261X2 + 7.395X3 + (-0.772)X4$$

Therefore, it can be concluded according to the results of multiple linear regression that management, independent commissioners, audit committees, and institutional ownership have a significant effect on the integrity of financial statements.

Table 2. Model Summary$_b$

Type	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.719a	0.517	0.509	851.228962	0.300

a. Predictors: (Constant), V4, V3, V2, V1

b. Dependent Variable: Y

Data source: *Research Data, 2023*

3.6 Coefficient of Determination

The test results obtained an *adjusted* R2 (adjusted determination coefficient) of 0.509. This shows that all independent variables simultaneously have an influence of 50.9% on the integrity of financial statements. While the remaining 49.1% was influenced by other variables that were not tested in the study.

3.7 Test t

The partial test (t-test) aims to evaluate the extent of the impact of independent variables on each dependent variable. In the context of this study, a significance value smaller than the α value is used as a criterion to determine significant results.

Table 3. Partial Test Results (t-Test)

Research Variables	Regression Coefficient	T count	Sig	Conclusion
(Constant)	117.157	.164	.870	
Institutional Ownership (X1)	.968	2.409	.017	Significant

Managerial Ownership (X2)	.261	.645	.519	Insignificant
Independent Commissioner (X3)	7.395	6.557	.000	Significant
Audit Committee (x4)	-.772	-3.641	.000	Significant

Source: Research data, 2023

The table of t-test results proves that independent variables have an effect on dependent variables, where:

1. The variable of institutional ownership has a positive influence on the integrity of financial statements, as seen from the regression coefficient of 0.968 and the sig value of 0.017 < 0.05.
2. Managerial ownership has no effect on the integrity of financial statements. The second hypothesis (H2) is rejected because management ownership has a sig value of 0.519 > 0.5, as indicated by the t-value of the table's statistical table.
3. The independent commissioner variable has a positive influence on the integrity of financial statements, indicated by the regression coefficient value of 7,395 and a sig of 0.000 < 0.05.
4. The variables of the audit committee have a negative and significant influence on the integrity of the financial statements, the regression coefficient is -0.772 and the sig is 0.000 < 0.05 indicating that the audit committee has a positive influence on the integrity of the financial statements.

The integrity of financial statements is positively and significantly influenced by institutional ownership, based on the results of tests (t-tests) conducted. This is supported by research (19) and (20) The integrity of financial statements is influenced by institutional ownership. The magnitude of the value of institutional ownership can help coordinate interests between management and shareholders. With the presence of institutional ownership, it will be difficult for companies to manipulate data in the presentation of financial statements. This will support the achievement of the goal of increasing the company's value through the submission of financial statements with a high level of integrity. Agency theory, says that institutional investors have good analytical skills, so that financial statements are not easily deceived by management. Thus, it can be concluded that high institutional ownership can improve the integrity of financial statements and prevent managers from committing fraud. If an institution owns shares in the company, they will expect the company's management to carefully prepare its financial statements.

Managerial ownership does not have a significant effect on the integrity of financial statements. Share ownership by the management does not guarantee the integrity of the financial statements, but will improve the performance of the management in the disclosure of financial statements. Basically, the shareholders have the same position. In line with research (20), (2) indicates that the integrity of financial statements is not affected by managerial ownership. The existence of small managerial ownership makes the interests of managerial owners a minority, so they do not have a significant ability to influence management decisions in the presentation of financial statements. Although managerial ownership should be able to improve the integrity of financial statements, due to the relatively small number of managerial ownership, their functions cannot operate optimally. Therefore, in this study, no significant influence was found between managerial ownership and the integrity of financial statements.

The integrity of the financial statements is proven to be influenced by the independent commissioner. This research is supported by (27) and (26) Independent commissioners have an impact on the integrity of financial statements can be improved through the effectiveness of independent commissioners in overseeing the company's governance system. An independent commissioner is a commissioner who does not come from the company's management team and is tasked with overseeing the accounting process in improving the integrity of a financial report. The independent commissioner's initiative provides guidance that encourages company management to act more carefully in the performance of its duties and tend to avoid moral hazard behavior. This is related to the Financial Services Authority Regulation No. 33/POJK.04/2014 of the Board of Directors and Board of Commissioners of Issuers or Public Companies, emphasizing that the duties of independent commissioners involve supervision of management policies, implementation of general management, and activities of public companies or issuers, while providing instructions to the board of directors. Thus, the position of an independent commissioner in an entity has the potential to strengthen the integrity of financial statements. This is due to the existence of a supervisory institution that monitors the process of preparing financial statements by management, so that it can prevent the presentation of information that may be misleading for users of financial statements.

The independence of the audit committee can affect the integrity of financial statements. In line with research (28) and (23) The integrity of the financial statements is influenced by the audit committee. The assessment given by the audit committee on financial statements, especially if it is increasingly complex, reflects the significant influence of the audit committee on the accuracy of the annual financial statements. The presence of more audit committee members can also increase the level of supervision, which contributes to improving the integrity of financial statements. A very crucial role of the audit committee is to protect the interests of shareholders from unwanted interventions. The agency supports commissioners by providing more accurate financial statements, minimizing opportunities for managers to interact excessively with commissioners, and providing advice on financial policies. The establishment of an entity's audit committee can help increase oversight of potential manipulation of financial statements, in line with agency theory. Therefore, the contribution of the audit committee is very meaningful in maintaining the integrity of the annual financial statements.

4. Conclusion

This study aims to evaluate the influence of *corporate governance mechanisms* on the integrity of financial statements. In this context, the elements *of corporate governance* are represented through institutional ownership, managerial ownership, independent commissioners, and audit committees. The findings of the study show that institutional ownership, independent commissioners, and audit committees have a significant influence on the integrity of financial statements. In contrast, managerial ownership has not been shown to have a significant impact on the reliability of financial statements.

Subsequent research, it is recommended to add additional variables to provide a more comprehensive understanding of corporate governance aspects, also considering different industry classifications. Adding a population and sample that can include a diverse range of company sectors not only in the manufacturing sector but also in the non-manufacturing sector. Increasing the trust of parties who use financial statements is expected to provide additional strength to integrity in the presentation of financial statements, so that it can support the survival of the company.

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