THE INDEPENDENCE OF EXTERNAL AUDITOR IN INDONESIAN FINANCIAL SECTOR THROUGH PERFORMANCE MANAGEMENT SYSTEM

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ABSTRACT
In a finding, the performance management system will significantly affect audits' quality in an organization. Moreover, the quality of an audit is influenced by the independence of an external auditor. We believe that the performance management system can affect the independent behavior of an external auditor as a constructive improvement tool. In this study, the researcher will focus on the independence of the Financial Services Authority in Indonesia in conducting audit supervision of banks. This thesis aims to see whether the performance management system in the Financial Services Authority in Indonesia has been effective and continues to be a constructive tool by evaluating the performance of these state-owned institutions. The researcher used a literature review method as a research method by analyzing scientific and professional journals, reports, news, and research. The researcher also used the interview method to find information from experts in the Financial Services Authority in Indonesia.

Keywords: Auditor's Independence, Performance Management System

PROBLEM DESCRIPTION

The more the company develops, the greater opportunity for fraud and non-compliance with the government to be hidden behind its accounting practices. In 2001 a big scandal happened. There were multiple-level audit failures by multiple parties, including several executive management team members at Enron and partners, auditors, and other employees at Arthur Andersen, which became known as the Enron Scandal. The failures make the organization obliged to evaluate potential auditors carefully before using their services.

An auditor is an individual who examines the accuracy of recorded business transactions. Auditors are needed to verify that processes are functioning as planned, and that the financial statements produced by an organization fairly reflect its operational and financial results (Bragg, 2020). Their respective roles can distinguish into two types of auditors, namely, internal auditor and external auditor. External audit should be independent from the government and the legislative body, and it should be carried out by professionals who have the appropriate professional and ethical competences that come from a wide range of experiences (Hysen Ismajli, 2019).

(Ojo, 2007) stated, "In view of the immense contribution by external auditors to the supervisory process, it is necessary to consider the risks associated with their involvement and provide for measures which would safeguard against any potential risks or threats to their independence." Because external auditors contribute immensely, they need to maintain organization and public trust towards the external auditors and make sure they provided the highest quality of audit to become an independent auditor. Therefore, auditors must obey the highest ethical and professional standards as they play an important role. To prevent failures that may be overcome by an organization, the company must carefully choose its external auditor. It is necessary to see their external auditor from various categories like their certification, fees, technology, experience, and the review from other industries that have used that auditor to know the reality of their reputational background (Zhang, 2018).

According to (Keuangan, 2017), the external auditor has an essential role in supporting the financial services sector's enforcement of market discipline. In maintaining an independent relationship between financial services authority and public accountant or public accounting firm,

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there is a need for regulations regarding public accountant and public accounting firm services in financial service activities. For instance, the Financial Services Authority in Indonesia has limited the use of audit services on the same public accountant's annual historical financial information for a maximum period of 3 years. In Indonesia, the Financial Services Authority uses an external auditor from a public accountant and public accounting firm to improve financial information quality and maintain transparency. The duties of the public accountant and public accounting firm's in the Financial Services Authority in Indonesia is to carry out the audits in the banking sector, capital market, or the Non-Bank Financial Industry (Keuangan, 2017).

A performance management system may be affecting the audit quality from an auditor's performance. (Sumners, 1994) found that "A carefully designed and administered performance appraisal system, which stresses the developmental aspect of evaluations, will provide the groundwork for improving the audit staff's performance more rapidly". Therefore, it is hoped that the performance appraisal will serve as a constructive output tool for external auditors and help eliminate the threat or reduce the threat to an acceptable level that may influence external auditor independence (Ojo, 2007).

This thesis will investigate the best practice of performance management system and how it increases external auditors' independence. Auditor independence is important because it has an impact on audit quality (Francis, 2011). (DeAngelo, 1981) found that audit quality is defined as the probability that the auditor will uncover a breach and report the breach. If auditors do not remain independent, they will be less likely to report irregularities, thereby impairing audit quality. (Andiola, 2014) confirmed that performance appraisals of external auditors are said to be an important tool to monitor audit quality. Therefore, the researcher believes that performance management system may have a significant impact on the audit's independence.The scope of this thesis will only be the Financial Services Authority in Indonesia. This thesis also needs to find the financial sector's influence on a performance management system's success and Indonesian culture's influence on an audit's independence.

RESEARCH QUESTION

In this study, the main questions that need to be answered is how can performance management systems within the financial sector increase the independence of the external auditor? The sub-questions for this paper are:

1. What is the influence of performance management systems on the independence of the external auditor?
2. What is the influence of the financial sector on the success of performance management systems in influencing the external auditor's independence?
3. How does Indonesian culture influence the independence of the external auditor?

RESEARCH METHODOLOGY

To answer the research questions, the researcher needs to conduct a literature review and do an interview. The researcher chose literature review and interview as methodologies in order to analyze how to guarantee the independence of the audits from the influence of performance management system in the financial sector, the influence from the financial sector as it will affect the success of performance management system in the external auditor's independence, and also how Indonesian culture effects on the independence of audit activity.

In this research, we will conduct a literature review if the availability of the information regarding the independence of audit, performance management on the financial sector, and the behave of audit from Indonesian culture effects. In order to ensure that the research stays on the right path of the topics at hand, the search terms focus on "performance management systems and independence of auditor", "financial sector influences on the performance management's success regards the independence of auditor", and "Indonesian culture and independence of audits", anywhere in the title or abstract.

The articles from journals, websites, newspaper, and magazine articles that are used in this research are selected based on the content and how it is relevant to the topic being research. The articles that are selected are articles whose primary focus is the independence of audit in financial sector, their application of their performance management, and how it influences the external auditor.

Based on these criteria several relevant articles have been researched under which: (Ojo, 2006) researched how auditor independence in the external auditor's role in banking regulation and supervision may threaten independence and efforts which have been introduced to act as safeguards to the auditor's independence. (Ojo, 2007) also stated the importance of the external auditor in the regulation and supervision to carry out direct supervisory functions in the supervisory process even when risks of conflict may exist.

For this research, the author will use a phone call interview using an available application, specifically Zoom. The researcher will conduct phone call interviews two until three times until this thesis ends. A phone call interview is used, which might be difficult to interview face-to-face due to the long-distance. From the interview’s answers, the researcher will do a proper analysis of the theories according to the journals from the literature review method and draw a conclusion from it.

RESEARCH OBJECTIVE

In conducting audits to the Commercial Banks and Rural Banks, Financial Services Authority needs to maintain public trust by guaranteeing its audit's independence. Therefore, this thesis wants to see whether the performance management has supported the external auditor's performance to become independent or not. Moreover, by writing this thesis, the researcher hopes that this thesis can evaluate the FSA's performance management system to provide constructive output to external auditors.

THEORETICAL FRAMEWORK

(Tysiac, 2021) on January 12, 2021, wrote that The AICPA Professional Ethics Executive Committee (PEEC) published a temporary policy statement to evaluate whether the AICPA Code of Professional Conduct (Code) should be revised because of recent SEC rules amendments related to auditor independence requirements. Moreover, (Meyer, 2020) based on Yellow Book or Government Auditing Standards told that the consideration of independence in a single audit is critical and has frequently been deficient based on peer reviews and federal agency reviews. External auditors' independence becomes the main concern for regulators to mitigate external auditor's issues to be not independent. External auditor plans and performs the audit of a bank’s financial statements to identify the presence or absence of material misstatements, whether due to fraud or error and are prepared in all material respects, following an applicable financial reporting framework. Moreover, the audit of financial statements may help identify weaknesses in internal controls relating to financial reporting at a bank, which may inform supervisory efforts in this area and contribute to a safe and sound banking system (Basel Committee on Banking Supervision, 2013). (Basel Committee on Banking Supervision, 2002) said, “In some countries, banking supervisors and external auditors already have closer relationships.” On the other hand, (Ertan, 2018) said, "Auditors should have little or no role in banking supervision for many reasons.”

Independence of External Auditor

The IFAC Code of Ethics for Professional Accountants states that accountants in public practice should be free of any interest that might be regarded as incompatible with independence. A misleading opinion is almost impossible to be proven unless the auditor admits so or the consequences of the it is uncovered (Irmawan, 2013). (Association of Chartered Certified Accountants, 2021) in their sites declared, an external auditor's independent role is vital to reinforce a company's financial statements and compliance with regulations. Auditors are also able to evaluate the effectiveness of internal controls within the company objectively. Hence, an auditor is obliged to issue reliable and credible financial statements.

Independence External Auditor Indonesia

In 1998, the Institute of Indonesia Chartered Accountants indicated ten Public Accounting Firms to have committed severe violations when auditing the liquidated banks. In addition, there are financial and managerial cases of public companies that cannot be detected by a public accountant, which causes the company to be fined by the Capital Market and Financial Institution Supervisory Agency (Dethan, 2016). Still (Irmawan, 2013) said, there is still limited publication on independence in Indonesia, especially regarding the perceptions of auditors and users of their reports that can pose a threat to auditor independence. Hence, there may be a lack of publication on Independence of Audit in Indonesia, leading to undetectable fraud in reporting the financial statements.

Even though the independent auditor regulations have been stated, at the end of 2018, one of the Public Accountants in Indonesia and the Public Accounting Firm which audited the financial reports of the largest airlines in Indonesia is sanctioned by the Financial Professional Development Center. That happens because the Public Accountant has not adequately assessed the substance of the transaction for the accounting treatment activities to recognize receivables and other income. The Public Accountant has not fully obtained sufficient audit evidence to evaluate the accounting treatment following the substance of the transaction agreement. Therefore, the Supreme Audit Agency asks the Public Accountant Firm to control the quality control standards (CNN Indonesia, 2019).

(Firmansyah, 2016), in their studies, suggested improving audit quality in Indonesia. It is better if the Public Accounting Firm regularly participates in its auditors to attend training held by the Institute of Indonesia Chartered Accountants. The Indonesian Institute of Accountants (IAI) states that audits conducted by auditors are said to be of quality if they meet auditing standards and quality control standards (Dethan, 2016).

Independence of Financial Services Authority in Indonesia

The People's Representative Council of Indonesia and the Republic of Indonesia made Law Number 21 of 2011 concerning the Financial Services Authority in Indonesia. The law defines the Financial Services Authority in Indonesia as an independent, integrated, and accountable institution with the function, task, and authority to regulate, supervise, examine, and investigate activities in the financial services sector.

FSA in Indonesia believes that the external auditor has an essential role in supporting their financial services sector's enforcement of market discipline (Otoritas Jasa Keuangan, 2017). The FSA determines Public Accountants and Public Accounting Firms as registered and listed Public Accountants and Public Accounting Firms to assist the FSA in auditing banks. The appointment of a Public Accountant and a Public Accounting Firm registered and listed by the FSA is decided by the General Meeting of Shareholders by the party carrying out financial services activities or the banks (Otoritas Jasa Keuangan, 2017). In maintaining public trust in the quality of financial information, parties carrying out financial service activities must maintain independent relationships with Public Accountants and Public Accounting Firms (Otoritas Jasa Keuangan, 2017).

Unfortunately, from 2018 until 2019, in Indonesia, two Public Accounting Firms were subject to administrative sanctions for incorrectly conducting audits of public companies' annual financial reports. Financial Services Authority (FSA) decided to impose sanctions on Sherly Jakom from Public Accounting Firm Purwanto, Sungkoro, and Surja for violating the capital market law and the code of ethics for the public accountant profession (CNBC Indonesia, 2019).

Relationship Indonesian Culture & Independence External Auditor

(Maryani, 2001) in (Irmawan, 2013) stated that religious values, education, organizational or work-related environment (e.g., employer's attitude or behavior, relations with colleagues, position in the management hierarchy, etc.), emotional quotient, family, experience, professional fee, legal system, and enforcement, affecting Indonesian accountants' ethical attitude and behavior. The interaction between people of different cultures is a daily phenomenon. According to (Rakhmat, 2003) in (Kalana, 2012) these different cultural characteristics can lead to conflict when these cultures interact with each other. Clients, both company owners, and company directors, often ask that the auditors who audit their company have the same cultural background or at least understand their culture. Auditors who have the same cultural knowledge or understand the client's culture will have no difficulty communicating or understanding clients both in terms of language.

In minimizing conflicts between different cultures, clients often request auditors' background qualifications to audit their company. One thing that supports allowing clients to choose their auditors personally is when the auditor is faced with a client who is not fluent in Indonesian. This situation requires the auditor to use the assistance of a translator in communicating with their client. In these conditions, clients often feel limited in providing company information that they have the right to access, which can affect the audit results. But still, auditor independence with the influence of culture and social interaction results has received little attention (Kalana, 2012).

Performance Management External Auditor

Performance appraisals of external auditors are said to be an important tool to monitor audit quality. Therefore, performance appraisal may significantly impact the audit's independence (Andiola, 2014). Unfortunately, the assessment and the promotion process may create a constructive or even a destructive atmosphere for audit output (Nehme, 2017). (KPMG Singapore, 2019), in evaluating their external auditor, the audit committee is assessing them with a formal review of the external auditor's adequacy, effectiveness, and efficiency—the performance assessment focus on individual perception towards the external audit. The internal auditor helps the audit committee with an additional fair and honest comment.

Each public accounting firm in each country has a different performance management system. Hence, the performance management system results will also produce different outputs for each external auditor in the public accounting firm. Kenya National Audit Office has an employee performance management system in place but still weak on the side of rewards (Obwaya, 2010). Moreover, from another performance management system in Scotland, General Auditor for Scotland implements the new Best Value regime as placing performance at the center where the auditor performance relies mainly on The Accounts Commission Statutory Performance Indicators (SPIs) (Midwinter, 2008).

Performance Management System Financial Services Authority in Indonesia

Financial Services Authority in Indonesia using QPR Metrics powered SIMPEL as their management system. FSA believes that QPR is the right choice for the organization, as it is very cost-efficient and fast to implement. The word SIMPLE is an Indonesian abbreviation that has the meaning "very easy" or simple. SIMPEL guarantees the FSA a better performance in the future, and it will prove the existence and performance to the stakeholders. SIMPEL performance management systems provide information for an appropriate reward to the employees. Individual performance metrics and bonuses are linked to the Key Performance Index. The bonus for the employee in FSA is based on their performance, given on an annual basis (QPR, 2021).

Strengths & Weaknesses concerning Independence of Financial Services Authority Indonesia

The strength of the FSA in Indonesia is to have state laws that contain the Financial Services Authority. Moreover, FSA budget funds are obtained from the State Revenue and Expenditure Budget and fees from clients. Because they have applied international best practices, the FSA can still maintain its independence in conducting regulation and supervision even though it levies on the banks it supervises. The communication system between the FSA and the monetary and fiscal authorities works well. In that case, FSA will help keep the stability of the micro-prudential and support the macro-prudential for the central bank (Sindonews, 2011). By becoming an independent supervisory agency for the financial services industry, the Financial Services Authority in Indonesia can protect the interests of consumers and society and turn the financial services industry into a pillar of the national economy that is globally competitive that can advance the general welfare (Otoritas Jasa Keuangan, 2017).

The first weakness is FSA in Indonesia imposed the clients or banks to pay their service. Still and all, the nominal amount of payment terms has been regulated in the applicable law of the FSA, which is related to state law, and payment of levies is also monitored in a system where bribery is not possible. Moreover, the FSA has adjusted the performance management system accordingly by adjusting the Balance Scorecard held by the FSA.

DATA ANALYSIS AND INTERVIEW

We can take from the theoretical framework chapter that the FSA in Indonesia can maintain its independence from levies from audited banks as stipulated by state laws and laws made by the FSA. In measuring all employees' performance, FSA uses QPR Metrics, which FSA in Indonesia believes that system is cost-efficient and fast to implement. The QPR metrics have been adjusted with the Balanced Scorecard owned by the FSA in Indonesia and are already linked to their Key Performance Index, aligning with their strategic direction.

The interview, which intends to complete the researcher's information regarding the FSA in Indonesia, is done by an online meeting. The result's answers have been combined, as shown below:

1. The implications of the Covid-19 pandemic have had an impact on the implementation of bank examinations, including the existence of face-to-face (social/physical distancing) exemption regulations and the application of work from home. Based on these considerations, the FSA has issued guidelines for Bank Examiners in carrying out their primary duties and functions in conducting on-site examinations of banks.
2. Before providing services (auditing and non-audit) to a Bank, public accountants and public accounting firms must first be registered with the FSA by applying for registration by fulfilling requirements such as having a valid license from the Minister of Finance, never being subject to administrative sanctions in the form of cancellation of the Certificate Registered from the FSA or the previous Authorities, have never committed a disgraceful act and/or been convicted of having committed a criminal act in the financial sector. Besides that, the FSA can ask for additional public accountants and public accounting firms registration requirements.
3. Board of Commissioners must consider the Audit Committee's recommendations. Before formulating recommendations, the Audit Committee must evaluate the implementation of the provision of audit services on annual historical financial information by the external auditor. After that, the Audit Committee can consider the external auditor's independence, the scope of the audit, the audit fees, the expertise of the Public Accounting Firm team, the methodology, techniques and audit tools used, etc.
4. Performance system already in line with the international standards include The Basel Core Principles (BCP) for Effective Banking issued by the Basel Committee on Banking Supervision (BCBS). Moreover, FSA's Key Performance Index in the system contains a strategic direction that creates the Financial Services Authority in Indonesia as an independent institution under the President of Indonesia's laws in the legislation.
5. The independent condition for the external auditor towards the bank during the audit period and the professional assignment period is if there are no conditions in the provision of such services:
   a. material financial interests
   b. employment relationship
   c. a material business relationship, including with key employees or major shareholders
   d. providing non-insurance services
   e. the provision of services or products on a contingent fee or commission basis
   f. legal disputes, and/or
   g. other matters that could create a conflict of interest
6. The FSA will trust external auditors who can provide independent audit services by reuse their audit services in the following year. Likewise, FSA employees who can get the findings (fact-finding) of violations committed by external auditors in providing services to banks will be considered to have good performance.
7. The FSA has affirmed that external auditors who behave dysfunctional, thus affecting the non-conformity with the actual condition of bank financial statements, will be subject to administrative sanctions. However, the FSA raises a possible cause for the auditor's dysfunctional behavior, namely:
   a. There is a conflict of interest between the parties involved in the audit assignment.
   b. Time budget pressure in the completion of financial reports.
   c. The financial compensation that was given to auditors based on a high or low income.

   d. The desire to move auditors is due to dissatisfaction with the work they are currently doing.
8. To prevent the potential for mutual pressure from the Banks to the auditor or vice versa, it is mitigated by the existence of regulations, including:
   a. FSA authorized to order the Bank in writing to replace the external auditor appointed by the Bank and audit or re-examine the Bank's financial statements.
   b. FSA can announce administrative sanctions on the Bank and the external auditor to the public.
9. Moreover, The FSA does not tolerate cultural influences such as language and equality of customs. The FSA, together with the board of commissioners and the audit committee, will continue to oversee the conduct of banks' audits so that there is no corruption, collusion, and nepotism.
10. The FSA also has the power to require the external auditor to submit the information requested by the FSA even though the employment agreement has ended.

CONCLUSION

To strengthen the global financial system is to issue a set of rules to provide a stable environment that meets international obligations (Basel Committee on Banking Supervision, 2011). Hence to support it, the Basel Committee, as the primary global standard-setter on Banking Supervision, published the Core Principles framework of minimum standards for sound supervisory practices considered universally applicable. In supervising banking in Indonesia, Financial Services Authority Indonesia regulates their system by making their regulations refer to the International Financial Reporting Standards and Basel Core Principles to realize a sustainable and stable financial system.

To uphold independence within the Financial Services Authority in Indonesia, Indonesia has regulated the Financial Services Authority in legislation as one of the institutions owned by the state. The Indonesian Basic Law forces the Financial Services Authority in Indonesia to become an independent, integrated, and accountable institution with the function, task, and authority to regulate, supervise, examine, and investigate activities in the financial services sector. The Law of Independence in the Financial Services Authority in Indonesia governs the security of budget funds when levies on audited banks; it will support the non-occurrence of corruption, collusion, and nepotism in the Financial Services Authority in Indonesia.

Auditor independence is important because it has an impact on audit quality (Francis, 2011). (Andiola, 2014) confirmed that performance appraisals of external auditors are said to be an important tool to monitor audit quality. Performance appraisals are an essential part of running an effective performance management system in FSA in Indonesia. Based on the analysis that has been concluded in the best practices in the financial sector in other countries, the researcher found that an effective performance management system can see the future performance help the organization achieve the targets. The researcher believes that the Financial Services Authority in Indonesia has implemented a constructive performance management system for auditors carried out by the Board of Commissioners.

The effective Performance Management System in the Financial Services Authority in Indonesia is helped by the performance appraisal conducted by the Audit Committee. The Audit Committee at the Financial Services Authority in Indonesia evaluates audit services on annual historical financial information. The evaluation is contained in the performance appraisals that the audit committee does. The Performance Management System in the FSA in Indonesia is declared effective because its performance appraisal looks at all past actions within a specified period. By conducting a performance appraisal which is also part of the Performance Management System, it is believed that it will fully support the vision and mission of the Financial Services Authority in Indonesia and the auditors' personal development goals.

Their performance management system, namely SIMPEL, can guarantee the FSA a better performance in the future, it will prove the existence and performance to the stakeholders (QPR, 2021). The SIMPEL system has been adjusted with the Financial Services Authority's Balanced

Scorecard in Indonesia and is already linked to their Key Performance Index, aligning with their strategic direction. With the regulation of state legislation, all systems within the Financial Services Authority in Indonesia have already prioritized independence. The Key Performance Index contains a strategic direction that creates the Financial Services Authority in Indonesia as an independent institution.

For this reason, audit quality influenced by an effective Performance Management System can positively impact audit quality performance. A good audit quality can lead to independence from the version of the auditor's performance. The Financial Services Authority's independence principle in Indonesia forces the Financial Services Authority in Indonesia to carry out its duties and authorities based on independence. The independence referred to is independence from decision-making and implementing the functions, obligations, and powers of the FSA.

POLICY AND LIMITATIONS

A sustainable performance management system will significantly affect the independence of banking supervision carried out by the Financial Services Authority in Indonesia. Therefore, the researcher will provide suggestions and recommendations to the Financial Services Authority in Indonesia regarding the current performance management system in this state-owned institution in this chapter.

First, the performance management system in the Financial Services Authority in Indonesia has been running well, as evidenced by the performance management system in line with the Key Performance Index containing their strategic direction. The Key Performance Index is linked to the individual performance metrics and rewards. The system can provide a future perspective on the institution to see future steps taken by the Financial Services Authority in Indonesia where an effective performance management system is created. Financial Services Authority in Indonesia could be more flexible in adjusting its system for employees' performance measurements and providing more protection to the data in the Financial Services Authority in Indonesia.

Data input in the administration carried out by the Audit Committee must be easy to operate to produce accurate data to support an increasingly integrated Financial Services Authority in Indonesia. Financial Services Authority in Indonesia could be more flexible in adjusting its system for employees' performance measurements and providing more protection to the data in the Financial Services Authority in Indonesia. Moreover from (Pulakos, 2004), she gives some recommendations towards an effective performance management system the following:

1. The system needs to be aligned with and support the organization’s direction and critical success factors.
2. Well-developed, efficiently administered tools, and processes are needed to make the system user-friendly and well received by organizational members.
3. Both managers and employees must use the system to bring visible, value-added benefits in performance planning, performance development, feedback, and achieving results.

Previously, we discussed the relationship between performance management systems and audit quality. Therefore, a performance management system that is always well developed can help the Financial Services Authority in Indonesia increase its independence in its performance when supervising banks, affecting the quality of audits at the Financial Services Authority in Indonesia.

The researcher also wants to convey the limitations contained in this thesis. In this thesis, the specific performance management systems owned by each financial sector in various countries are not detailed in-depth due to the lack of information regarding the performance management systems of the financial sectors in other countries. The lack of information makes the researcher unable to provide comparisons between countries to find best practices that can be used as benchmarks for the performance management system owned by the Financial Services Authority in Indonesia. However, Financial Services Authority in Indonesia is already running on banking supervision regulations with international standards issued by the Basel Committee.

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