Corporate Governance and the Incidence of Sanctions in the Indonesian Capital Market

by

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Abstract

A lack of prudent corporate governance practice has been identified as a significant contributor to the Asian economic crisis, which hit the region, including Indonesia, in 1997. In response to the crisis aftermath, in 2001, Indonesia implemented an improved set of corporate governance principles through the establishment of a national committee and corporate governance code. These corporate governance principles have also been incorporated into relevant laws and regulations.

With the adoption of corporate governance principles, the remaining issue is the assessment of the effectiveness of corporate governance in Indonesia. On the one hand, reviews by the World Bank and the International Monetary Fund (IMF) (2004, 2010) have highlighted that Indonesia has mostly incorporated good corporate governance principles into its regulatory framework in the form of law, regulations and sanctions. However, these same commentators point out that corporate governance practices in Indonesia are often distant from what is required by regulation and code, and they recommended that Indonesia improve the effectiveness of its good corporate governance implementation and enforcement.

Past studies have mostly focused on the effect of corporate governance on the behaviour of management, company performance, reporting quality and firm value. These studies appear less relevant for developing countries like Indonesia because the findings are inconclusive and are specific to the countries or regions in which the studies are conducted. Further, they are largely based on the conditions and environment of developed countries. Only a handful of studies have evaluated the relationship between corporate governance and the incidence of sanctions in developing countries. Even in these cases, the findings of these studies are subject to the legal, social and political environmental conditions of the economies in which they are conducted, and the findings have little or no relevance for the Indonesian situation. Further, Indonesia follows a civil law legal system and two-tier board system structure that differs from the one-tier systems found in many other countries. As such, in-depth analysis of corporate governance practices under a variety of governance structures and regulatory regimes, including under two-tiered systems such as that of Indonesia, is required.

For that reason, the analysis of the effectiveness of corporate governance in Indonesia is an interesting area of research, especially its effectiveness in preventing the incidence of

sanctions. In this study, the main purpose of implementing good corporate governance is to curb fraudulent behaviour and business failures and to protect the interests of stakeholders. The aim of the study is thus to conduct a detailed review of the current state of corporate governance, by measuring the relationship between corporate governance and the incidence of sanctions, and then by estimating a model to predict the incidence of sanctions subject to a set of corporate governance attributes.

The Indonesian corporate governance implementation is measured using four groups of attributes as proxies: Ownership Structure (OS), Board of Commissioners (BoC), Audit Committee (AC) and External Auditor (EA). Each category is further divided into some specific observable attributes that become the independent variables. The dependent variable, Incidence of Sanctions, is a dichotomous variable. The sample data is 1205 Indonesian-listed companies, covering the period 2007–2010, and representing about 74% of the population. All the variables are obtained from secondary resources through company annual reports. The multinomial logistic regression model is employed to test the hypotheses, measure the relationships and predict the probability of sanctions.

The results show that only four out of nine independent variables have a significant relationship with the incidence of sanctions. These are Top Shareholder, BoC Size, BoC Meeting Frequency and AC Meeting Frequency. The findings, while failing to provide supporting evidence for all of the hypotheses, do provide greater insights into the state of corporate governance in Indonesia with respect to breaches and subsequent sanctions. However, the results have not found strong support for the arguments about the effectiveness of corporate governance in preventing the incidence of sanctions in the Indonesian capital market. Nor has the two-tier board system structure produced any favourable outcomes over and above the one-tier Board structure. One of the most prevalent findings is high ownership by top shareholders, further confirming the concentration of ownership in Indonesia. This fact is further evidence of the agency problem between majority and minority shareholders in public corporations in Indonesia.

As an additional outcome of this study, the predictive model developed provides a useful tool for determining the probability of a company being sanctioned, given a set of corporate governance attributes.

Declaration

I, Boby Wahyu Hernawan, declare that the DBA thesis entitled 'Corporate Governance and the Incidence of Sanctions in the Indonesian Capital Market' is no more than 65,000 words in length including quotes and exclusive of tables, figures, appendices, bibliography, references and footnotes. This thesis contains no material that has been submitted previously, in whole or in part, for the award of any other academic degree or diploma. Except where indicated, this thesis is my own work.

Signature: [redacted] Date: 2 December 2016

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Table of Contents

List of Figures

List of Tables

List of Appendices

List of Abbreviations

AAER	Accounting and Auditing Enforcement Releases
AC	Audit Committee
ACE	Audit Committee Effectiveness
AGO	Attorney General Office
ASIC	Australian Securities and Investment Commission
BoC	Board of Commissioners
BoD	Board of Directors
CASE	Cairo and Alexandria Stock Exchange
CEO	Chief Executive Officer
CFR	Cash Flow Right
CGPI	Corporate Governance Perception Index
CR	Control Right
EA	External Auditor
FCGI	Forum for Corporate Governance in Indonesia
GMS	General Meeting of Shareholders
IDX	Indonesia Stock Exchange
IICD	Indonesian Institute of Corporate Directorship
IICG	Indonesian Institute for Corporate Governance
IMF	International Monetary Fund
IOS	Incidence of Sanctions
IPO	Initial Public Offering
JSE	Johannesburg Stock Exchange
JSX	Jakarta Stock Exchange
LPM	Linear Probability Model
LR	Likelihood Ratio
ML	Maximum Likelihood
NCG	National Committee on Governance
OECD	Organisation for Economic Co-operation and Development
OJK	Otoritas Jasa Keuangan
OS	Ownership Structure
RPT	Related Party Transactions

ROSC	Report on the Observance of Standards and Codes
SA	South Africa
SOE	State Owned Enterprise
SPV	Special Purpose Vehicle
SRO	Self Regulatory Organisation
SSX	Surabaya Stock Exchange

Chapter 1: Introduction

1.1. Introduction

Corporate governance has a range of definitions. The Organisation for Economic Co-operation and Development (OECD) broadly defines corporate governance as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders”. In addition, The Cadbury Committee (Cadbury Report, 1992, para. 2.5) mention that “corporate governance is the system by which companies are directed and controlled”.

In contrast, Shleifer and Vishny (1997) narrowly define corporate governance as matters that concern “the ways in which suppliers of finance assure themselves of getting a return on their investment”. In this definition, ‘suppliers of finance’ refers to the suppliers of capital; that is, the owners of or investors in a company who supply finance in the form of owners’ equity, rather than to creditors, who also supply finance to a company in the form of liabilities.

In more detail, Monks and Minow (1996) give the definition of corporate governance as:

> ...the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by chief executive officer), and (3) the board of directors... Other participants include the employees, customers, suppliers, creditors, and the community.

Given the range of definitions discussed in the literature, Claessens (2006) categorised the definitions of corporate governance into two categories. The first category comprises the definitions related to the day-to-day behaviour patterns of corporations. These behaviours or attributes have characteristics that are measurable, including performance, efficiency, growth, financial structure and the behaviour of stakeholders. The second category is those definitions that focus on the normative corporate governance framework, which is built around the various systems and environments within which corporations operate, and includes the legal system, regulatory environment (corporate regulation and market regulation) and stakeholder-related factors.

The view of corporate governance is generally focused on the differences of interests between two parties: owners, who provide the finance and take risks, and managers, who run the company (Shleifer & Vishny 1997). The objective of the owners is to maximise the long-term value of the company, whereas the objective of the managers is private benefits such as control and incentive payments. This misalignment or conflict of interests is known as the principal–agent relationship problem (agency problem). This agency problem theory was first introduced by Jensen and Meckling (1976), who argued that the agency problem arises when the agent (management of corporation) is not acting in the interests of the principal (owners of corporation). Therefore, sound corporate governance mechanisms are needed to align the conflicting parties' interests to benefit the owners.

However, Hart (1995) argued that corporate governance would always be an issue for corporations in the presence of the agency problem because of a lack of contractual structures capable of eliminating, or even minimising, the outcomes of agency problems. This situation of conflict of interest creates a cost, known as 'agency cost', which is associated with management incentives and monitoring costs to ensure that the agent always acts in the best interests of the principal (Jensen & Meckling 1976). Some of these conflicts could be minimised by various contractual agreements among the relevant parties. However, contracts are not always possible to mitigate all aspects of the agency problem for two reasons. First, it is not possible to include all eventualities that raise conflicts into contract settlements. Second, there are some costs associated with negotiating contracts and enforcing them. Therefore, corporate governance mechanisms remain an issue for organisations, now and in the future (Hart 1995).

1.2. Research Background

It is clear from the literature and from government regulatory approaches that corporate governance will become increasingly important in the future. This will necessitate the establishment of various facilitating structures and the implementation of supporting legislations and policies. Due to the role played by corporate governance in improving economic efficiency and growth, as well as in improving investor confidence, the OECD has strongly emphasised the need for greater attention to this aspect of corporations (OECD 2004).

The global financial crisis, which surfaced in 2008, is attributable to the many corporate scandals and mismanagements that occurred in the early 2000s. In relation to these events, Yong (2009) argues that "effective governance is needed to direct world economies out of the global financial crisis—it is about acting ethically and properly in all business transactions so that business may be carried out with confidence". His argument further emphasises the importance of corporate governance, especially in relation to dealing with economic crises.

In connection with the contribution of corporate governance to Asian economies between 1960 and 1995, Pistor and Wellons (1999) argue that the gradual adoption of laws and regulations has played an important role in establishing what the World Bank calls 'The East Asian Miracle'. The corporate governance framework has generated credibility in general for the Asian economies, and confidence among investors with their investment decisions (Pistor & Wellons 1999). This has also been the case in Indonesia, where the implementation of good corporate governance encourages fair competition and creates a conducive business environment that support sustainable economic growth and stability (NCG 2006).

Indonesia was significantly affected by the East Asian economic crisis that began in 1997. This event was the result of the failure of prudent corporate governance, especially as regards ineffective board supervision control and a lack of transparency (Alijoyo et al. 2004). In relation to this, in 2004, the World Bank and the International Monetary Fund (IMF) assessed Indonesian corporate governance compliance through their Report on the Observance of Standards and Codes (ROSC), which recognised that Indonesia had adopted most corporate governance principles as laws and rules, and therefore rated it as a 'partially observed' economy. The updated ROSC in 2010 recognises that Indonesia's corporate governance practices have improved significantly, although the economy is still rated as 'partially observed'. The improvement is mainly attributable to the amendment of Company Law in 2007 and some revisions on rules and regulations by the regulator. However, the 2010 ROSC highlighted that some areas require further improvement, including as regards the Board of Commissioners' (BoC) duties, the accounting and auditing framework and ultimate shareholder disclosure (World Bank & IMF 2010).

In November 2009, the Financial Standards Foundation, an international non-profit organisation that promotes transparency in political and economic affairs, awarded 'enacted' status to Indonesia based on its level of compliance to principles of corporate governance. 'Enacted' status is awarded to countries in which governance information is publicly available and most corporate governance principles have been incorporated into relevant laws and regulations, but where the actual enforcement of these laws and regulations has not been assessed (eStandardsForum 2009).

Thus, the remaining issue is the assessment of the effectiveness of corporate governance in Indonesia. On the one hand, reviews by the World Bank, IMF (2004, 2010) and eStandardsForum (2009) have highlighted that Indonesia has mostly incorporated good corporate governance principles into its regulatory framework in the form of law, regulations and sanctions. On the other hand, these same sources identify that corporate governance practices in Indonesia are often distant from what the regulation and code requires, and they recommend that Indonesia should increase the effectiveness of good corporate governance implementation and enforcement (World Bank & IMF 2004). Hence, the analysis of the effectiveness of corporate governance as weighed against the incidence of sanctions is an interesting area of research.

Past studies have focused on the effect of corporate governance on the behaviours of management, company performance, reporting quality, firm value and the incidence of fraud (for example, see Gompers, Ishii & Metrick 2003; Bhagat & Bolton 2008; Karamanou & Vafeas 2005; Beasley 1996). These studies appear less relevant to developing countries such as Indonesia because the findings are inconclusive and are heavily dependent on specific country and regional characteristics. Further, the difference in approach to putting the corporate governance system into practice is another reason that the findings from developed countries are less relevant to developing countries. The approach practiced in developing countries, particularly in Asia, is more relationship-based as opposed to rules-based, as in developed countries. Alongside the differences in the cultural and legal system, this is a significant factor (Clarke 2007). In addition, few studies have looked at the effectiveness of corporate governance in protecting stakeholders from the adverse effects of decisions made by the board and from fraudulent behaviour. The few studies that have focused on the topic have focused on benchmark measurements such as agency costs, firm value, company performance and disclosure quality.

A few studies have evaluated the relationship between corporate governance and the incidence of sanctions in developing countries, for examples in China (see Chen et al. 2006; Jia et al. 2009) and South Africa (see Mangena & Chamisa 2008). However, the corporate governance implementation process varies among countries according to the differences in the legal framework and corporate structure and, to a limited extent, the prevailing business culture. Therefore, the findings from other developing countries may have limited application to the Indonesia situation. Further, Indonesia adopts a two-tier board system structure that differs from the one-tier system found in many other countries. In this two-tier board structure, the supervisory board that represents stakeholders and the management board that manages company operation are separate. In the one-tier system, the roles of Board Chairman and Chief Executive Officer (CEO) are combined (Clarke 2007).

Differences in countries’ legal systems may also affect the effectiveness of corporate governance. This argument is supported by Vafeas and Theodorou (1998, p. 384), who argued that “various governance structure should be separately examined in each country”. In Indonesia, the National Committee on Governance (NCG) has assessed the implementation of corporate governance by developing a corporate governance rating. In addition, the Indonesian Institute for Corporate Governance (IICG), an independent body of professional members, has developed the Corporate Governance Perception Index (CGPI). Both governance ratings have been in place since 2001; however, as the assessment is entirely voluntary, currently only 98 of the 422 public companies in Indonesia have been assessed (IICG 2013).

Currently, the effectiveness of corporate governance practice in relation to the incidence of sanctions in the Indonesian capital market is not well understood. As mentioned previously, Indonesia does not have a comprehensive governance rating that measures the implementation of corporate governance, especially for public companies. Findings of this study could provide useful information with regard to the incidence of sanctions for misconduct in the Indonesian capital market and fill the gap identified in the ROSC.

A study on the effectiveness of corporate governance in limiting the incidence of sanctions in developing countries that have adopted a two-tier board system would enrich the corporate governance literature. The importance of corporate governance in preventing fraud and business failure has been identified by Donker and Zahir (2008, p. 88), who argue that “good governance will only reduce fraud, save corporation money on director and officer insurance, lawsuits, and reduce business failure”. Further, Mukweyi (2010, p. 67) states that “good corporate governance should ensure that no stakeholder is fraudulently short changed by insiders in the firm”.

1.3. Research Problem

Since 2001, owing to the establishment of the NCG and the implementation of the Code of Corporate Governance, corporate governance practices have undergone significant changes in Indonesia. The World Bank, IMF (2004 and 2010) and eStandardsForum (2009), having assessed the Indonesian corporate governance implementation, has given Indonesia the status of ‘partially implemented’ or ‘enacted’ for its corporate governance practices. However, the effectiveness of corporate governance in Indonesia, especially in relation to the ability to reduce the incidence of sanctions or to enforce laws and regulations has not been researched extensively. This is reiterated by Claessens (2006), who asserts that enforcement of corporate governance laws and codes is one area of the corporate governance literature that needs further investigation.

Theoretically, the implementation of corporate governance principles should affect company operations, including minimising the adverse outcomes of any sanction or enforcement action by the regulator (Donker & Zahir 2008, Baker & Anderson 2010). Given the nature of the Indonesian civil law legal system, which is different to those of other countries in the region, and the two-tier corporate board structure, this study provides a unique opportunity for expanding the body of knowledge.

1.4. Research Objectives

This study aims to examine the relationship between good corporate governance practices and the incidence of sanctions by the regulator of the Indonesian capital market. The basic hypothesis is that good corporate governance practices will reduce any incidence of sanctions. The specific research objectives are:

1. To provide a comprehensive review of the corporate governance attributes of the Indonesian capital market.
2. To investigate the relationship between corporate governance and the incidence of sanctions or enforcement actions in the Indonesian capital market.
3. To estimate a model to predict the probability of an entity receiving sanction, subject to a set of attributes.

Addressing these objectives will provide an assessment of Indonesia’s corporate governance practices by measuring their effectiveness to reduce the incidence of sanctions or enforcement actions. The findings will also serve to verify the findings in the corporate governance reports by the World Bank and the IMF (2004, 2010) and eStandardsForum (2009).

1.5. The Importance of the Research

The study will shed new light in some areas and further light in others on the relationship between the incidence of sanctions and enforcement actions on the one hand, and the nature of corporate governance in developing countries on the other. The existing literature comprises studies on the effect of corporate governance on the opportunistic behaviours of management, company performance, reporting quality and firm value. Some studies have observed the impact of corporate governance on the occurrence of fraudulent activities, but most of these have focused on the one-tier board structure system. In contrast, this study makes a wider observation, not only on fraudulent activities, but also on any incidence of sanction or enforcement action received from the regulator under the two-tier board structure system.

Measuring the effectiveness of corporate governance in Indonesia in terms of its ability to prevent any incidence of sanctions would benefit regulators, corporations and other stakeholders. The study will review the corporate governance attributes based on the Indonesian code and regulation requirements, and then it will examine the relationship between these attributes and incidence of sanctions. A comprehensive review of these attributes will provide insight into the specific nature of corporate governance in Indonesia with respect to the structure of concentrated ownership and the two-tier board structure. Further, the results from the determination of the relationship between corporate governance attributes and the incidence of sanctions could be used as an evaluation tool by regulators for reviewing corporate governance codes and regulations. Finally, the findings could help management in evaluating which specific governance attributes require improvement to maximise their effectiveness.

1.6. Methodology

The basic proposition for this study is that corporate governance practices prevent public companies from being sanctioned by regulators. For this Indonesian case, corporate governance practices are measured using certain corporate governance attributes. As done in previous studies (for example Beasley 1996; Chen et al. 2006; Mangena & Chamisa 2008), these corporate governance attributes are the independent variables in the study. These attributes have been selected to reflect the main attributes and specific governance condition in Indonesia, and can be categorised into four groups: Ownership Structure (OS), BoC, Audit Committee (AC) and External Auditor (EA). Each main group of attributes is then further divided into the specific measurements that form the independent variables in this study.

Ownership Structure is represented by Top Shareholder (OSTop), Number of Block-holders (OSBlock) and Ownership by Board Members (OSBoard5Percent). The BoC attributes are measured by Board Independency (BocIndSize), Board Size (BocSizeClass) and Board Meeting Frequency (BocMeetFreq). The AC attributes are classified into AC Expertise (ACExpSize) and AC Meeting Frequency (ACMeetFreq). The External Auditor attribute is measured through External Auditor Quality (EAQual).

The dependent variable in this study is the Incidence of Sanctions. There is a possibility that the sanction given is not the final imposition, as companies have the right to appeal. However, based on the sanctions data set used for the period of observation, it was confirmed that there had been no appeals processes against those sanctions. This study thus considers all sanctions data as final impositions.

This study also incorporates the control variables of Firm Size (AssetClass), Listing Age (AgeClass) and Industry (Industry). Firm size is measured in terms of total company assets, listing age is determined by years since the company's initial listing in the capital market, and industry reflects the nature of the company's business; that is, financial or non-financial.

The data on corporate governance attributes and the occurrence of sanctions was collected in a sequential fashion to capture the effect of the corporate governance in place before any incidence or non-incidence of sanctions. Hence, data for the dependent variable (Incidence of Sanctions) were collected for a year following the observed corporate governance variables. The data set is unbalanced, as the study especially focuses on the occurrence of sanctions, which vary in their incidence from year to year.

The sample data of this study is secondary by nature because it is gathered from the annual reports and financial statements of listed companies in the Indonesian capital market, for the period 2007–2010. The data on the sanctions against listed companies were sourced from

Bapepam-LK through its website, annual reports and press release documents for the relevant period.

Multivariate analysis using a logistic regression model was employed to measure the relationship between the corporate governance variables and the incidence of sanctions, as the incidence of sanctions is a dichotomous dependent variable. Further, the logistic regression equation model developed in this study can predict the occurrence of sanctions based on a set of corporate governance attributes.

1.7. Thesis Structure

This thesis is organised as follows. Chapter 1 has introduced the study, including the research background, research problem, research objectives, the importance of the research and the research methodology. Chapter 2 provides the literature review relevant to the study, including corporate governance conceptual theory, the taxonomy of corporate governance, corporate governance codes and principles, factors affecting corporate governance, corporate governance attributes and empirical research on the effectiveness of corporate governance. Chapter 3 provides an overview of the regulatory framework and corporate governance conditions in Indonesia, including a discussion of the legal system and institutional framework, corporate governance condition and related enforcement action in Indonesia.

Chapter 4 then elaborates the research hypotheses and research design. Chapter 5 analyses and discusses the results, including presenting the descriptive statistics and model testing. Finally, Chapter 6 summarises the findings, conclusions and recommendations of the study, and presents the study's limitations and some possible areas for future research.

Chapter 2: Literature Review

2.1. Introduction

The corporate governance literature has extensively discussed corporate governance's basic tenets and practices, and the expected outcomes of its implementation. Hence, a comprehensive coverage of corporate governance theories and practices is required. The next seven sections in this chapter attempt to provide such coverage.

Section 2.2 of this chapter commences with a discussion on the conceptual theory of corporate governance, which consists of finance, stewardship, stakeholder and political models. Section 2.3 presents a corporate governance taxonomy that introduces different implementation regimes, followed by Section 2.4, which discusses corporate governance principles, to extend understanding further. Section 2.5 addresses the internal and external factors affecting the corporate governance system. Next, Section 2.6 reviews common corporate governance attributes, including those of Board of Directors (BoD), AC and EA.

The effectiveness of corporate governance implementation, including the effect on agency cost, firm performance, disclosure and firm value, based on previous studies is discussed in Section 2.7. Finally, Section 2.8 highlights the effectiveness of corporate governance for preventing the incidence of sanctions/fraud, which is the central concern of the remainder of this thesis.

2.2. Conceptual Theory of Corporate Governance

Since the topic of corporate governance covers broader issues such as relationships and mechanisms within firms and with other stakeholders, it is essential to consider a multi-theoretical approach to understand further corporate governance issues that may enhance the functioning of organisations (Daily, Dalton & Cannella 2003). Letza, Sun and Kirkbride (2004) summarise the four major views of corporate governance in the US: the finance model, the stewardship model, the stakeholder model and the political model. The finance model, or the agency theory model, focuses on shareholder value and alignment of interests between shareholders (principals) and management (agents). This is the dominant view of corporate governance in the current literature. The stewardship model is similar to agency theory; however, it takes the opposite behaviour approach as regards management, who are seen as loyal and acting as stewards to shareholders. The stakeholder model views corporations as affected by and exposed to diverse stakes in the social context, as well as to shareholders' interests. The political view argues that the pressure of the political condition results in various corporate governance models among nations. Further, national politics are seen by this model as affecting the corporate governance arrangement inside the firm (Roe 2003).

2.2.1. Finance Model

The finance model is concerned with the universal agency problem and the alignment of interests between shareholders and management. Agency theory is a dominant theory in finance, as it underlines the concept of corporate governance. The work of Berle and Means (1932) was the starting point of the concept of the modern corporation. Nowadays, ownership of corporations is evolving, from a single owner into more diverse and widely distributed ownership. Since more owners are involved, they have to delegate their control to an agent/management. This condition creates separation of ownership and control. Shareholders as owners have to give up their control rights (CR) to managers (Berle & Means 1932).

However, this situation is not new. In 1776, Adam Smith (cited in Clarke 2007, p. 4) commented on company management in his famous masterpiece 'The Wealth of Nations':

> Being managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which partners in a private co-partner frequently watch over their own. ... Negligence and profusion, therefore, must always prevail more or less in the management of the affairs of a joint stock company.

The separation of ownership and control has come to be known as the agency relationship. Jensen and Meckling (1976) define the agency relationship as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent" (Jensen and Meckling 1976, p. 5). Further, Jensen and Meckling (1976) point out that the separation of ownership and control creates a misalignment of interests between shareholders as the principal, and the manager as the agent (the principal–agent problem). Shareholders want to see their shares grow in value (long-term vision), whereas managers tend to focus on their personal interests during their contract with the company (short-term vision).

Eisenhardt (1989) also discusses the agency problems that result from the agency relationship between principal and agent. The author notes two problems associated with this relationship: the agency problem and the problem of risk sharing. Firstly, the agency problem arises when the principal is not always able to monitor the actions of the agent. Secondly, the different attitude towards risk between the principal and the agent creates the problem of risk sharing.

In addition to the misalignment of interests (also known as the horizon problem) between principal and agent, another source of conflict arises from the moral hazard problem (Ward, Brown & Rodriguez 2009). This moral hazard derives from the information asymmetry between shareholders and management, in which managers possess more information about the company than do shareholders. This situation motivates managers to acquire private benefits for themselves at the expense of shareholders, such as excessive perquisites or adverse selection of investment opportunities (Ward, Brown & Rodriguez 2009).

Consequently, the principal (shareholders) has to monitor the agent's (manager) behaviour to reduce the potential for conflicts of interests and minimise the issue of information asymmetry. Such monitoring efforts involve an additional cost known as agency cost (Jensen & Meckling 1976). However, despite this, Fama (1980) and Fama and Jensen (1983) argue that the separation of ownership and control is the only viable form of economic organisation, especially in large corporations with diverse shareholdings.

As such, a corporation is viewed as a 'nexus of contract', both written and unwritten, between all suppliers of production factors and customers. These contracts specify each party's rights and obligation to each other and become the internal 'rules of the game' of corporations (Fama & Jensen 1983). Shleifer and Vishny (1997) argue that to align the interests of managers with those of shareholders, and to achieve shareholders' objectives without any material misappropriation from managers, corporate governance is required to ensure managers focus on the principal's interests.

However, although comprehensive contracts exist among all participants in a corporation, these contracts are not always able to anticipate all possible circumstances or conditions. Thus, corporations invariably face an 'incomplete' contract or agency problem, making it necessary to have a mechanism to protect each participant's rights and obligations. This mechanism is called corporate governance (Hart 1995).

The agency theory is also referred to as a ‘finance model’ due to its focus on maximising shareholders’ interests, and reliance on the free-market economy and efficiency as a prerequisite. Shleifer and Vishny (1997) extend the focus of the finance model not only to shareholders’ interests, but also to debt-holders and bankers as well.

Daily, Dalton and Cannella (2003) contend that the agency theory is the most popular concept when explaining corporate governance issues. The popularity of agency theory is because it is simple and based on human behaviour. The simplicity of the theory is reflected in the concept of reducing large and complex corporations into simple components of shareholders and management issues. Secondly, that individuals are more interested in their personal gain (self-interest) and are reluctant to sacrifice their interests to others is recognised as human nature (Daily, Dalton & Cannella 2003).

Blake (1999) observed an additional agency issue called the ‘double agency dilemma’. This dilemma is often found in a more complex structure of corporation, and it arises because of the separation of ownership and control. In this structure, shareholders appoint a BoD as their representative and the BoD assigns managers to perform the daily operation of the corporation. The double agency dilemma arises firstly from the relationship between shareholders and the BoD, and secondly from the relationship between the BoD and management (Blake 1999).

Kraakman, Armour and Davies (2009, pp. 88–89) further elaborate the agency problem. They argue that instead of only one pair of agency problems between shareholders and managers as previously understood, there are actually three pairs of agency problems in the current corporate structure: (1) shareholders (principal) and managers (agent); (2) minority shareholders (principal) and controlling shareholders (agent); and (3) creditors (principal) and shareholders (agent). In relationship to number (1) and (3), the agent controls the investment made by the principal, and the agent could secure benefits for themselves at the expense of the principal’s investment. A slightly different viewpoint is applied to relationship number (2), in which the agent (controlling shareholders) might expropriate the principle (minority shareholders). These situations would create agency problems.

The agency problem is usually divided into agency problem type I and type II. Type I agency problems have their source in the separation of ownership and control, where there is a misalignment of interests between shareholders (principal) and managers (agent) (Jensen &

Meckling 1976). Baker and Anderson (2010) summarise the sources of problems as the self-interested nature of management (moral hazard), management's retention of earning policy where the company's profits are not distributed to shareholders, different time horizon views between principal and agent, and managerial risk aversion by management.

Type II agency problems refer to the conflict between majority and minority shareholders (La Porta, Lopez-de-Silanes & Shleifer 1999). In the modern corporation, where ownership is widely held by the public, there are conflicts between majority shareholders (dispersedly owned by large holders) and minority shareholders, who are usually the founders or their family. Even though minority shareholders only own a small fraction of total company shares, they still have substantial control over the company. Thus, they could expropriate other shareholders' value through the arrangement of the OS such that voting rights and cash flow rights (CFR) are unbalanced, for example by issuing dual-class shares and pyramidal ownership.

Type II agency problems do not necessarily come from only minority shareholders. Majority shareholders can also expropriate minority shareholders' interests, especially in a concentrated ownership situation. In this case, the majority shareholders already own substantial control through holding a large percentage of shares, with the potential for them to expropriate minority shareholders' value.

Connelly, Limpaphayom and Nagarajan (2012) argue that type II agency conflict occurs more frequent in the case of family firms. This is because family/founder cronies are able to obtain significant control, either by direct ownership or indirectly through complex OSs and participation within management. This creates a greater possibility for withdrawing private benefits of control.

Therefore, it is the role of corporate law and corporate governance mechanisms to minimise the agency problem and balance the information asymmetry between parties (Kraakman, Armour & Davies 2009). In relation to the corporate governance area and its functions to reduce the agency problem, there are two distinct corporate governance mechanisms common in the literature: internal mechanism and external mechanism. The corporate governance internal mechanism consists of the internal arrangement of specific company organs and their procedures, such as the BoD, executive compensation and OS. The external corporate governance mechanism deals with the force of the free-market economy and efficiency to discipline management in accordance with the interests of shareholders. This external mechanism is usually referred to as a ‘market for corporate control’ and it mostly takes the form of a takeover market.

2.2.2. Stewardship Model

The stewardship model takes an opposite approach to agency theory, arguing that managers do not always behave for their own self-interests. While the agency theory suggests that managers will always pursue their own private interests rather than those of shareholders or the company, the stewardship model proposes that this is not always the case.

Davis, Schoorman and Donaldson (1997) argue that management is able to maximise shareholders’ wealth through maximising company performance, which they could achieve out of a motive to increase their self-esteem, and from an attitude to serve the best interests of all. This argument is the basic tenet of the stewardship model.

This concept is derived from organisational psychology and organisational sociology. The organisational role-holders (that is, executives/manager) are motivated to bring their organisation towards its best performance because this improves their self-esteem and brings them recognition from peers and bosses (McClelland 1961; Herzberg et al. 1959, as cited in Donaldson & Davis 1991). In addition, this model argues that collectivistic behaviour as part of an organisation stands above the individual egos of executives. Although the divergence between the interests of shareholders and managers still exist, this model considers that cooperative behaviour will support the achievement of the long-term goal of the corporation, which is in line with shareholders’ objectives. Managers, for the sake of collectivistic feeling, have to be assumed as serving a longer tenure to the corporations (Davis, Schoorman & Donaldson 1997). Therefore, it is expected that executives/managers will become good stewards of the corporation and set aside their personal interests (Donaldson & Davis 1991).

Further, Clarke (2007) states that stewardship model recognises the wider motives of managers such as orientation towards achievement, altruism and commitment to meaningful work. Managers are motivated to perform at their best and maintain their integrity when they are appointed to manage a company. They will be a good steward for their principal (shareholders) and will not act opportunistically. The incidences of misalignment of interests would be minimal, as managers will do their best to balance all interests of shareholders and stakeholders by taking the best decisions for all (Davis, Schoorman & Donaldson 1997).

2.2.3. Stakeholder Model

The stakeholder model is a conceptual theory of corporate governance that derives from the contrasting perspectives of shareholders and stakeholders' relationship with corporations (Letza, Sun & Kirkbride 2004). The shareholder perspective is that a company is a legal vehicle, as mandated by corporation law, through which shareholders can maximise their wealth from their return on investments. The law has ordered a specific structure and mechanism for a company, including that it has general meetings of shareholders (GMS) and appoints a BoD and management to protect shareholders' interests.

In contrast, the stakeholder view, which evolved only in the late twentieth century, considers corporations as a meeting point for various wider participants to settle their interests together. This concept, introduced by Freeman (1984), recognises many relationships and associations between corporations and diverse stakeholders, and does not focus on shareholders' interests alone (Letza, Sun & Kirkbride 2004).

The stakeholder model of governance focuses on parties surrounding the corporation. Freeman (1984) argues that 'a stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization's objectives' (Freeman, 1984, p. 46). Clarke (2007) finds that corporations have multilateral agreements between the enterprise and its multiple stakeholders. The relationship between the corporation and its internal and external stakeholders is framed by formal and informal agreements developed for the life span of the corporation, and businesses should pay attention to the rules and agreements between parties (Clarke 2007). The importance of stakeholders within corporations, such as customers and employees, is further emphasised by Lozano (2005). He argued that the existence of corporations could be severely affected by these stakeholders, as they provide important resources to corporations.

Blair (1995) argues that shareholders are not the only party that have a specific right to company assets. Other parties beyond shareholders and investors have institutional arrangements to support the company and contribute to the company's specific assets. Management's duty is to create total wealth to the whole enterprise. Hence, management has to consider all stakeholders' concerns (Blair 1995).

Spitzeck and Hansen (2010) state that the significant role of stakeholders in corporations is usually referred to as instrumental stakeholder theory. This view builds a corporate governance concept that all interests of stakeholders should be considered when governing and directing corporations. However, Donaldson and Preston (1995) point out that corporations should only focus on the stakeholders that affect firm value. The stakeholder governance approach proposes that dominant stakeholders should be given more attention, as retaining their support is important to the success of the corporation (Spitzeck & Hansen 2010).

The stakeholder concept had been evolving even before it was familiarised by Freeman (1984). Friedman (1970) advocated that corporations as a part of the business mechanism should not be disturbed by performing social functions within society. Corporations serve to make a profit for their shareholders through free-market mechanisms, as these individuals purposely invested their money to generate an investment return. Social responsibility, Friedman (1970) argued, is the domain of the government, charities and other social bodies within society. The only social responsibility for corporations is to increase its profits (Friedman 1970).

Clarke (2007) also criticises corporate governance based on the stakeholder model. The stakeholder model requires management to consider the concerns of all parties. Hence, Clarke (2007) argued that this approach would create more space for management to take actions perceived to be in the interests of all stakeholders, even though this would not necessarily create value for shareholders as their major concern.

2.2.4. Political Model

Roe (2003) also introduces a political model of corporate governance, grounded in an economic and law theory background. The political theory is an alternative to economic/law theories, to explain certain corporate governance models. The author argues that political pressure, such as ideology, party system and the political orientation of the government, shapes the corporate governance arrangement. Specifically, the political context will affect shareholders' ownership dissemination, and interaction among managers, owners, employees and other stakeholders.

With regard to ownership diffusion, a strong social democracy, in which diverse stakeholders' voices are heard in corporations in addition to shareholders' claims, tends to be characterised by more share ownership concentration. Social democracy creates diverse claimants to firms. Hence, shareholders wishing to protect their interests in the company have to maintain adequate ownership by become block-holders. In addition, having various claimants to the company dissuades potential investors from ownership, unless they can hold significant influence in the company to protect their interest. This situation further encourages concentration of ownership (Roe 2003).

Roe's political approach to the corporate governance model, especially with regard to shareholder ownership dispersion, confronts the established theory of quality of corporate law by La Porta, Lopez-De-Silanes and Shleifer (1999), who state that the degree of share ownership dispersion in a country is dependent on the quality of its investor protection rights within corporate law. However, Roe (2003) contends that countries with a similar quality of corporate law (that is, investor protection) rarely have a similar degree of share ownership diffusion, as advocated by La Porta, Lopez-De-Silanes and Shleifer. Hence, Roe (2003) argues that political context contributes more to shaping the characteristics of share ownership dispersion than does quality of corporate law.

2.3. Corporate Governance Taxonomy

The discussion of corporate governance issues among scholars and practitioners in the international context lacks coherency (Weimer & Pape 1999). Most of the corporate governance literature has focused at the firm level, rather than the country level. At the country level, no theoretical framework has been developed that supports the international corporate governance system.

Weimer and Pape (1999) introduced a taxonomy of corporate governance that characterises corporate governance practices around the globe. Their effort identifies the three major differences between countries while applying corporate governance practices as legal, institutional and cultural background. Based on these differences, Weimer and Pape (1999) examined eight characteristics and finally proposed a four-category general taxonomy of the corporate governance system.

The eight characteristics examined were the prevailing concept of the firm, the board system, the salient stakeholder ability to exert influence on managerial decision making, the importance of stock markets in the national economy, the presence or absence of an external market for corporate control, the OS, the extent to which executive compensation is dependent on corporate performance, and the time horizon of the economic relationship (Weimer & Pape 1999).

Derived from these eight characteristics, Weimer and Pape (1999) classify the international corporate governance system into four groups: (1) Anglo-Saxon countries (the USA, the UK, Canada and Australia); (2) Germanic countries (Germany, the Netherlands, Switzerland, Sweden, Austria, Denmark, Norway and Finland); (3) Latin countries (France, Italy, Spain and Belgium); and (4) Japan (which is considered isolated).

In addition to Weimer and Pape's (1999) taxonomy, Baker and Anderson (2010) classify the corporate governance system into Market-based versus Bank-based systems, Insider versus Outsider systems, and Civil law versus Common law systems. The market-based and bank-based system classifications rely on the characteristics of the corporation's fund provider. Equity markets and debt markets are the major sources of funds in the market-based system, whereas banks are the suppliers of funds in the bank-based system. Examples of market-based corporate governance systems are the US and the UK, whereas France, Germany and Japan are grouped as bank-based governance systems (Hicks 1969; Chandler 1977, 1984, as cited in Baker & Anderson 2010).

The classification of Outsider and Insider systems of corporate governance is credited to the works of Franks and Mayer (1996, 2001, as cited in Baker & Anderson 2010). The outsider corporate governance system is characterised by advanced equity and debt market economies, a dispersed OS and an active takeover market. Conversely, the insider system of corporate governance is characterised by high concentration of ownership through a complex OS, family or other dominant shareholders in control of corporations, and an inactive market for corporate control. The US and the UK are classified as outsider systems, while most of Continental Europe could be classified as having an insider system of corporate governance.

La Porta et al. (1998) introduced a new conceptualisation of the corporate governance system in which there is a strong relationship between ownership characteristics and investor legal protection. Based on this premise, La Porta et al. (1998) observed two distinct legal families, Common law and Civil law. Common law countries have the strongest investor protection, while Civil law economies present the weakest protection for investors' rights and interests. Further, La Porta et al. (1998) contend that to compensate for weak investor protection, investors will protect themselves from expropriation by collecting more stakes and control in corporations. Hence, concentrations of ownership are prevalent in Civil law countries due to their lower investor protection, while dispersed ownership is observable within Common law regimes because of their stronger investor protection. These law and finance mechanisms are the basic assumptions of the corporate governance system classification between Common law and Civil law systems.

Table 2.1 Taxonomy System of Corporate Governance

Taxonomy/Aspects	Anglo-Saxon	Germanic	Latin	Japan
Market/Network-oriented System of Corporate Governance	Market-oriented	Network-Oriented		
Countries	USA, UK, Canada, Australia	Germany, the Netherlands, Switzerland, Sweden, Austria, Denmark, Norway, Finland	France, Italy, Spain, Belgium	Japan
Concept of the Firm	Instrumental, Shareholder-oriented	Institutional	Institutional	Institutional
Board System	One-tier	Two-tier (supervisory and executive board)	Optional (France), in general one-tier	Board of directors; office of representative directors; office of auditors; de facto is one-tier
Salient Stakeholder(s)	Shareholders	Industrial banks (Germany), employees, in general oligarchic group	Financial holdings, the government, families, in general oligarchic group	City banks, other financial institutions, employees, in general oligarchic group
Importance of the Stock Market	High	Moderate/High	Moderate	High
Active External Market for Corporate Control	Yes	No	No	No
Ownership Concentration	Low	Moderate/High	High	Low/Moderate
Performance-dependent Executive Compensation	High	Low	Moderate	Low
Time Horizon of	Short term	Long term	Long term	Long term

Economic Relationship				

Source: Weimer and Pape (1999, p. 154).

2.4. Corporate Governance Codes and Principles

As the importance of corporate governance has become more of an issue over the last decade, agreement has been reached that that guidance on good corporate governance is essential. The code of good corporate governance specifies a set of best practice recommendations around company BoD and corporate structure arrangements and procedures to minimise agency conflicts and increase shareholders' value (Aguilera & Cuervo-Cazurra 2009).

The issuance of the UK's Cadbury Report (Code) in 1992 sparked debate all over the world about the need for a good corporate governance code. While the Cadbury Code was not the first of its kind (the first corporate governance code was introduced by the US in 1978), it inspired many countries to follow and develop their own code. Further, the support from international organisations such as the OECD highlighted the importance of corporate governance best practices and boosted the development of good corporate governance codes around the world (Aguilera & Cuervo-Cazurra 2009).

The 1992 Cadbury Report has been regarded as an international benchmark for good corporate governance practices. More importantly, this report introduced the 'comply or explain' approach, in contrast to the mandatory system introduced by the US through the Sarbanes Oxley Act in 2002 (Arcot, Bruno & Faure-Grimaud 2010). The 'comply or explain' approach allows voluntary compliance with the code. However, it is mandatory that companies disclose why they are not complying with certain provisions. Hence, in essence, the 'comply or explain' approach is a mandatory disclosure obligation towards any state of implementation of the code (Arcot, Bruno & Faure-Grimaud 2010). In contrast, the mandatory approach translates corporate governance best practices into law and regulation, for example through the Sarbanes Oxley Act 2002, making the implementation of good corporate governance practices become mandatory.

Arcot, Bruno and Faure-Grimaud (2010) argue that the flexibility offered by the 'comply or explain' approach leads to a better corporate governance environment. This is because voluntary compliance and a space for flexibility encourage corporations to understand the spirit of the code and create more responsibility. By contrast, the mandatory approach forces corporations to follow strictly any law or regulation stipulation. This encourages a ‘box ticking’ mentality, whereby a company will do their best to comply with regulations on paper, even where this may not be reflected in their practice (Arcot, Bruno & Faure-Grimaud 2010). However, further research shows that the flexibility of the ‘comply or explain’ principle does not always encourage firms to improve their governance practices. Some companies continually choose the ‘explain’ approach, rather than trying to better ‘comply’ with the principle in subsequent periods. This situation may arise due to weaknesses of monitoring and enforcement action from the regulator (Arcot, Bruno & Faure-Grimaud 2010), and could undermine the positive aspect of the ‘comply or explain’ principal.

Similar to the above approach, there are ‘soft law’ and ‘hard law’ approaches with regard to corporate governance best practice recommendations. The soft law approach incorporates good governance best practice into codes and recommendations that are voluntary in nature. This approach is sometimes also termed an ‘ethics-based’ approach, since it relies on the ethical behaviour of the firm. In contrast, the hard law approach adsorbs best practice recommendations into law and regulation, to be implemented in a mandatory fashion. This approach is sometimes called the ‘regulatory-based’ approach. Debates continues among scholars and practitioners regarding the extent to which each approach has improved the good corporate governance environment (Aguilera & Cuervo-Cazurra 2009).

Following from the landmark issuance of the Cadbury Code in 1992, the OECD, with the assistance of the World Bank and Asian Development Bank, issued their international code in 1999. Since 1999, the OECD’s Corporate Governance Principles have been agreed on as the basis for corporate governance as an initiative among OECD member and non-member countries; they were revised in 2004 (OECD 2004). The Principles were developed mainly to assist OECD and non-OECD countries to evaluate and improve their legal, institutional and regulatory frameworks for corporate governance. These principles targeted public companies, but they are also applicable to stock exchanges, investors, corporations and any business party involved in developing good corporate governance practices.

The OECD Corporate Governance Principles focus on the central problem of governance; that is, the separation of ownership and control. However, many factors affect governance and the decision-making process within the firm. Therefore, the Principles should be considered in conjunction with other governance issues such as controlling over minority shareholders, and bribery.

The OECD Principles recognised that no single model could adequately address the corporate governance issue across all countries. Therefore, they were revised to contain only the common elements. This enables the formulation of different models for different countries. Moreover, as the Principles are non-binding and contains no detailed prescription, they only serve as reference points for policy makers in developing legal and regulatory frameworks (OECD 2004). They are also evolutionary in nature and will be regularly reviewed to accommodate world economic changes. The OECD Principles are also used as the basis for the World Bank and IMF's ROSCs.

2.5. Factors Affecting Corporate Governance Systems

The mechanisms of the corporate governance systems can be classified into two major streams: internal and external. Internal corporate governance mechanisms refer to certain intentionally implemented procedures within firms by shareholders/stakeholders or the regulator, while external mechanisms result from spontaneous market functioning in a free-market economy towards efficiency (Naciri 2008).

Internal corporate governance mechanisms include OS, BoD' arrangement and executive compensation, and can be implemented by shareholders, stakeholders or the regulator, to maximise shareholders' value and provide better investor protection. External mechanisms discipline managers, making them perform optimally for shareholders' value. This mechanism is commonly termed the market for corporate control, which includes the takeover market.

Baker and Anderson (2010) also argue that OS (an internal mechanism), market for corporate control (an external mechanism), and legal family origin (that is, Common or Civil) affect and shape the corporate governance system.

2.5.1. Internal Corporate Governance Mechanism

2.5.1.1. Ownership Structure

The OS of a corporation is crucial in shaping its corporate governance system. The owners' identity, how they own the corporation and how much influence they possess over it are important considerations affecting the corporate governance process. In addition, the OS has an effect on the effectiveness of corporate governance and affects corporate performance and firm market value.

As the agency theory generally assumes that shareholders are homogenous and their influences are proportional to their stakes, Kang and Sorensen (1999) argue that shareholders are usually categorised into different classes, and that the OS of an organisation is strongly correlated with firm performance. The importance of OS is also identified by Shleifer and Vishny (1997), who argue that in the absence of legal protection, investors will tend to have a concentration of ownership to protect themselves from management misappropriation and to minimise the agency problem.

In the area of corporate governance research, there are two major types of corporate OS: diffused ownership and majority-controlled (or block-holder) ownership (Koh 2008). These two ownership categories are grouped as proportional ownership. Apart from these two, there is an additional OS type, referred to as disproportional ownership, where the CR is not in line with the CFR. This is a deviation from the 'one share–one vote' principle (Adams & Ferreira 2008).

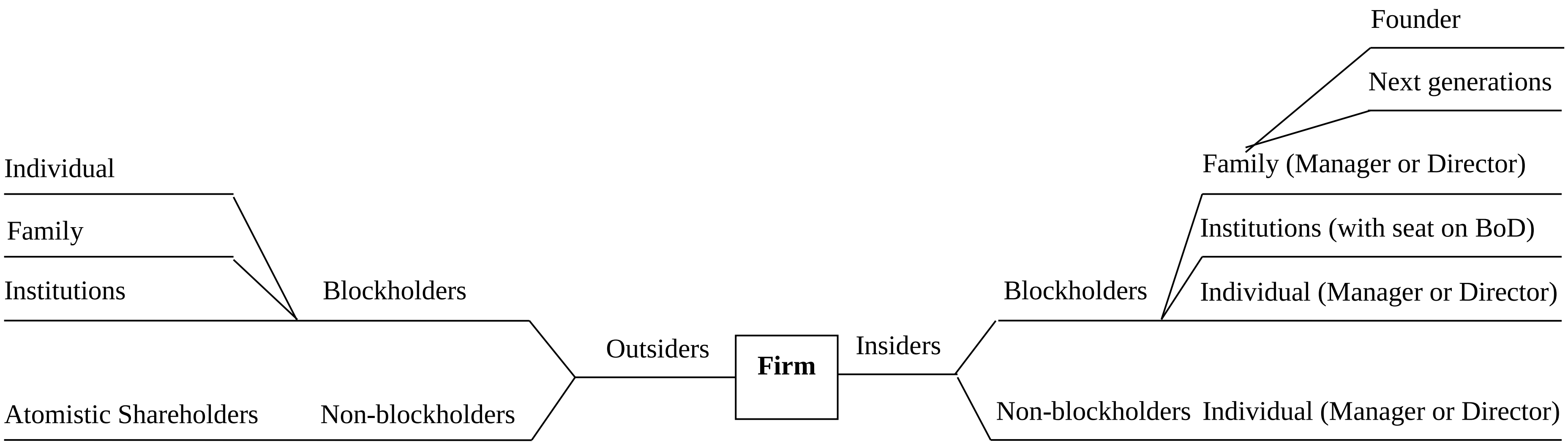
CFR refers to the actual ownership in a company based on actual investments made (shares purchased), whereas CR represents voting rights owned by (ultimate) owners in a company (Claessens, Djankov & Lang 2000). In normal conditions, CFR and CR should be equal. However, there are conditions in which this equality does not hold (disproportionate ownership), such as in dual-class equity structures, stock pyramids and cross-ownership. Bebchuk, Kraakman and Triantis (1999, as cited by Koh 2008) mention that this type of ownership in widely held firms is also called 'minority-controlled ownership', and resembles a mix of the characteristics of diffused and majority-controlled ownership.

Shleifer and Vishny (1997) further explored the issue of OS in relation to agency theory. They argue that OS also depends on industry characteristics. Larger firms tend to have diffused ownership due to the high cost associated with shareholding and the ease of securing control attached to big firm's shares. Diffused ownership is a common feature among high-risk firms, as individual shareholders are likely to be more risk averse; and majority-controlled firms are mostly found in countries that have weak legal investor protection rights (Shleifer & Vishny 1997). Extending this point, Setia-Atmaja (2009) found that ownership concentration has a negative impact on board independence, but does not affect AC independence.

With regard to equity structure and owners' identity, Jensen and Meckling (1976) categorise shareholding into inside and outside equity. Inside equity refers to shares owned by managers, whereas outside equity relates to shares held by anyone outside the firm. Inside ownership is sometimes referred to as managerial ownership, where managers also own a portion of the company's shares. Referring to the type I agency problem, managerial ownership could support the alignment of interests between principals and agents, as managers would also have a sense of belonging to the company. Therefore, it is expected that managers will perform their duty cautiously, as they are also owners of the firm. Additionally, managerial ownership would enhance the alignment of interests between insider and outside shareholders; although, only in the case of a portion of ownership. Otherwise, it would create more problems through the entrenchment effect (Morck, Shleifer & Vishny 1988).

Baker and Anderson (2010) explain the ownership class taxonomy in relation to corporate governance. There are two broader classifications of shareholders, insiders and outsiders. Insiders include shareholders whose shares represent direct ownership, such as by management as part of the alignment of interests mechanism that seeks to make managers more responsible in taking care of their corporation due to having a stake in it. Outsiders are those atomistic (dispersed) owners of a corporation. Figure 2.1 summarises the shareholder taxonomy classifications.

In relation to the OS across different countries, the Anglo-American economies (the US, the UK, Australia and New Zealand) are mostly characterised by diffused equity ownership. In these economies, shares are widely distributed among individuals and institutions, with institutional shareholders holding large amounts of shares (Clarke 2007, p. 129). Faccio, Lang and Young (2001) and Faccio and Lang (2002) state that, as in East Asia, most Western Europe corporations are controlled by concentrated ownership by family. The agency theory refers to this concentrated ownership as 'crony capitalism', and any expropriate actions usually come from controlling shareholders.



Source: Baker and Anderson (2010, p. 316)

Figure 2.1 Ownership Class Taxonomy

In the East Asia region, Claessens, Djankov and Lang (2000) investigated the OSs of nine countries. They state that disproportional ownerships, in which CRs exceed CFRs, are very common in the form of pyramid structure and cross-holdings. Moreover, the separation of ownership and control are frequently observable in family-controlled firms, almost 66% of which are controlled by single shareholders. Further, older firms tend to have concentrated ownership, whereas younger firms are likely to be dispersed in ownership. Further, managers of family firms are usually family relatives of the controlling party, and the majority of wealthy firms are owned by a few families or a family clan (Claessens, Djankov & Lang 2000).

Research shows that when controlling shareholders possess more CR and are more involved on the board, the function of corporate governance in that firm is less effective. In addition, the role of outside independent directors is less prevalent due to small representation on the board, resulting in a less effective monitoring function (Lin et al. 2012). Family ownership also has a negative impact on the relationship between the board's subcommittees, especially for the remuneration committee, and negatively affects public companies' performance (Lam & Lee 2012). The pyramidal structure of ownership results in lower firm value and cancels out the benefits of adopting good corporate governance practices. Hence, challenging the effectiveness of the corporate governance implementation (Connelly, Limpaphayom & Nagarajan 2012).

While the literature argues that in the US corporation ownership is widely dispersed, current research by Holderness (2009) challenges the categorisation of the OS of US corporations. He argues that ownership concentration of US corporations is similar to in other countries; that is, concentrated, and he confronts the notion that OS is more concentrated for countries with weak investor protection.

2.5.1.2. Board of Directors

The BoD is a company organ that represents the interest of shareholders, especially in the US context. The board's roles are to hire, monitor, compensate and fire management, all with the intention to maximise shareholders' wealth (Fama & Jensen 1983). According to Fama and Jensen (1983) and Jensen (1993), the BoD is an internal control mechanism within an organisation that aims to reduce the agency problem and progress towards value creation for shareholders. In addition, Adams and Ferreira (2008) argue that the BoD performs an advisory function, advising the management in various operations.

To highlight the importance of the BoD further, Conger, Finegold and Lawler (1998) give the analogy that the role of the board is similar to that of a fire department. Firefighters do not work every day. However, when a fire occurs, they have to promptly and prudently extinguish that fire (perform very well), otherwise everything will be ruined. The observable function and assessment of a board during normal times might be irrelevant in judging their effectiveness. However, periodical assessment may help to ensure proper functioning of the board and its elements for when they are needed most.

As a representative of shareholders and the holder of a fiduciary role, the BoD performs its function to oversee management by two primary actions, monitoring and rewarding management. Thus, a strong and independent BoD is very important to protect shareholders' interests (Ward, Brown & Rodriguez 2009).

The corporate governance literature has examined a wide range of characteristics of BoDs across countries and their impact on company decision making and performance. Most of the characteristics examined are related to the size of the board, board member independency from management and shareholders, the background and capability of board members, and the dedication of board members in terms of their meeting frequency and multiple duties of members in other companies (Baker & Anderson 2010). Achmad (2007) groups these BoD characteristics into three main categories: size of the board, composition and independency, and internal structure and functioning.

In theory, the role of the BoD is considered an important mechanism for corporate governance. However, the board's role has not been fully confirmed in practice, as it is promoted theoretically (Denis & McConnell 2003).

2.5.1.3. Executive Compensation

The agency theory by Jensen and Meckling (1976) states that the principal–agent conflict could be minimised by formulating appropriate incentives for management so that management could perform at its best for the company and eliminating moral hazards. The BoD, as the representative of owners (principal), sets the optimum management remuneration that acts as a reward for performance and as a tool to align principal and agent interests. In addition to setting up the appropriate compensation package for management, the board also has to monitor management. These tasks are the main tasks of the board affecting the internal mechanism of firm corporate governance (Hermalin & Weisbach 2003). Cianci, Fernando and Werner (2011) suggest that stronger corporate governance (that is, better monitoring by the board) will have an inverse relationship with compensation package.

The traditional agency theory assumes that the compensation contract operates under an arm's length basis, providing a partial remedy to overcome agency problems. However, under the managerial power theory, compensation is not always at arm's length, especially considering the 'de facto' power of managers to influence board members to increase the compensation packages offered, especially when governance implementation is weak (Barkema & Pennings 1998). Evidence suggests that managers with more power receive greater compensation packages (Bebchuk & Fried 2004).

As advocated by agency theory, executive compensation is positively correlated with firm performance and the minimisation of agency cost. In support of this claim, some studies have examined the relationship between executive compensation and performance. For example, Conyon and He (2011) found that executive compensation is positively correlated with firm performance among listed companies from China. In relation to recent corporate scandals and collapses, Petra and Dorata (2008) argue that executives' compensation is one factor that contributed to the collapses, alongside weaknesses in the corporate governance structure. They studied the relationship between level of performance-based incentives for CEOs and corporate governance structure (that is, BoD characteristics and the presence of a compensation committee), and found that CEO duality (where an executive that serves as CEO is also a member of the board) increases the performance-based incentives for CEOs.

A study by Warren et al. (2011) researched the relationship between corporate fraud and CEO compensation through the formation of nomination and remuneration committees to appropriately reward CEO. They found that certain types of compensation, including stock-option compensation for CEOs, tended to motivate CEOs to commit corporate fraud. This fraud was in the form of illegal statements or earnings management. In contrast, salaries and bonuses given as cash were not directly related to fraud engagement (Warren et al. 2011).

2.5.2. External Corporate Governance Mechanism

2.5.2.1. Market for Corporate Control

As the external corporate governance mechanism is influenced by free and efficient market power, there are two broad rationales for why takeover markets exist in the free-market economy: industry-specific motives (synergistic between firms) and as mechanisms to discipline management (Dickerson, Gibson & Tsakalotos 2002, p. 1170).

The industry-specific motive deals with specific benefits of synergy, including creating economic of scales, reducing competition, easier access to financial providers and gaining monopoly power. This could be achieved either through vertical or horizontal integration.

The market for corporate control, commonly known as the takeover market, refers to a corporate governance disciplinary mechanism in a market-oriented economy. In essence, corporations have to be performing well by utilising all their assets/potentials, otherwise another party will take them over and endanger their current management. This is considered the most severe governance mechanism that disciplines corporations and their management and board. This mechanism functions when a company is believed to be underperforming or to have hidden assets that are not being fully utilised by management. In this case, they could become a target for takeover from other party (Clarke 2007). In relation to corporate governance practice, the existence of markets for corporate control helps the BoD and management to perform their duty to the best of their ability by adding value to all stakeholders. Otherwise, they could lose their jobs because of corporate takeover or acquisition.

Franks and Mayer (1996, as cited by Baker & Anderson 2010) have classified the corporate governance system into outsider systems and insider systems. The outsider system of corporate governance is associated with the presence of sophisticated equity and debt markets in the economy, dispersed ownership and an active market for corporate control. Conversely, the insider system of corporate governance is characterised by long-term concentrated ownership by family. This ownership stability, in addition to legal barriers to hostile takeovers, creates a barrier to an active market for corporate control.

In the US, the importance of the market for corporate control as an external corporate governance mechanism has been highlighted by Denis and McConnell (2003). They argue that the takeover market is an "important corporate governance mechanism, a 'course of last resort' for assets that are not being utilized to their full potential" (Denis & McConnell 2003, p. 19).

This argument is also examined by Franks and Mayer (1996), who surveyed the hostile takeover markets in the UK. They report that, in the UK, the takeover market is quite active, and that following takeovers, there is often significant board member turnover and a major restructuring of firms. However, there is little evidence that hostile takeover bids are a response to poor performance. Hence, Franks and Mayer (1996) challenge the notion that hostile takeovers are an important disciplinary mechanism.

In Germany, the market for corporate control is rare, possibly because of the concentrated ownership characteristics of that country's equity market. However, it does exist, although in a different form to takeovers in the US and UK (Denis & McConnell 2003). Jenkinson and Ljungqvist (2001) researched the takeover markets in Germany and confirm that the potential acquirer obtains their significant stakes in the target firm through purchasing blocks of shares from current block-holders.

Further, the market for corporate control as an important corporate governance mechanism is not supported in many other countries (Denis & McConnell 2003). For example, in the Netherlands, the takeover market is more restricted than in other countries because there are multiple antitakeover devices (Kabir, Cantrijn & Jeunink 1997). In China, Xu and Wang (1997) argue that an active market for corporate control is not present. Denis and McConnell (2003) explain that the high concentration of ownership in public corporations may lie behind the non-existence of takeover markets in these countries.

2.5.2.2. Legal Family Origin

La Porta et al. (1998, as cited in Clarke 2007, p. 91) raise a 'law matters thesis', explaining that the level of ownership dispersion is dependent on the extent to which minority shareholders are protected by the law. This argument is based on the premise that shareholders (investors) are willing to invest more if their rights are better protected. Consequently, more investors are attracted to funding a company and expect some returns, leading to a more dispersed ownership. Moreover, the legal family origin of a country (that is, Civil law or Common law) will affect how minority shareholders are protected, thus influencing the dispersion of share ownership.

La Porta et al. (1998) argue that better minority shareholder protection by law will correspond to a higher level of ownership dispersion (lower concentration of ownership). As a result, with reference to legal family origin (Common law versus Civil law countries), there are two noticeable types of OS. The Common law countries, for example the US, the UK and Australia, have stronger minority shareholder protection within their legal jurisdiction. Therefore, the level of ownership dispersion is high (dispersed OS). By contrast, Civil law economies, such as France, Germany and Italy, provide weaker protection to minority shareholders, with a higher concentration of ownership being observed.

Concentrated OS is the result of weak shareholder protection. As there is no strong investor protection by law and regulation, shareholders need to protect their investment by collecting more stakes towards ownership concentration. Ownership concentration enables shareholders to exercise their power and rights (by holding a majority of shares) in circumstances of minimal law and regulation (La Porta et al. 1998).

La Porta, Lopez-de-Silanes and Shleifer (1999) found evidence that the concept of separation of ownership and control by Berle and Means originated from the Anglo-American economy. They argue that, for the rest of the world, OS is typically concentrated and family-owned, with little evidence to support the concept of separation of ownership and control.

In summary, whether the legal family origin of a country is Common law or Civil law is a significant determinant of the level of shareholder protection afforded in that economy. The level of shareholder protection shapes the OS, with strong legal protection giving rise to dispersed ownership and enabling a separation of ownership and control, whereas weak shareholder protection tends to generate concentrated ownership and prevent separation of ownership and control (Baker & Anderson 2010, p. 40).

2.6. Corporate Governance Attributes

The OECD Principles of Corporate Governance (OECD 2004) have specified basic principles to assist countries to develop good corporate governance frameworks. The principles focus on establishing an effective framework, the OS, equitable shareholders' rights, the role of stakeholders, sufficient disclosure and the role of the BoD.

In discussing the OECD Principles, the corporate governance literature has elaborated the principles into corporate governance attributes that are easy to measure and observe. The attributes reflect the basic principles of implementation at the operational level in corporations. These attributes can be grouped as relating to the BoD, the AC or EA. The next section will discuss the common attributes of the three areas.

2.6.1. Board of Directors Characteristics

2.6.1.1. Board Size

Board size refers to the number of members on the BoD. Previous literature has studied the role of board size, but the findings are inconclusive, especially as regards the direction of the relationship between board size and firm performance. However, Dalton et al. (1999) argue that larger board size may be advantageous to firm performance, in term of its capability to acquire more resources and accommodate more independent members. In relation to earnings management, Xie, Davidson and DaDalt (2003) support the argument for a large board size. Larger board size means a higher probability of having independent directors with the expertise needed to prevent earnings management.

Opposing this view, Jensen (1993) and Lipton and Lorsch (1992, as cited by Hermalin and Weisbach 2003) argue that a larger board is less effective than a smaller board. Yermack (1996) states that smaller boards form a strong relationship with firm value. These findings support smaller board size as more effective. Further, small board size gives advantages in respect to better financial ratio value and CEO incentives. Huther (1997), in his study, also found a negative relationship between board size and firm performance. Eisenberg, Sundgren and Wells' (1998) study supports the notion of a negative correlation between board size and profitability, especially among small and medium size firms. Mak and Kusnadi (2005) and Andres, Azofra and Lopez (2005) further support the finding that board size has an inverse relationship with firm value.

2.6.1.2. Board Independency

In relation to board structure, Moerland (1995) argues that board characteristics are different across countries. With reference to Anglo-Saxon countries (such as the US, the UK, Canada, and Australia), he classifies boards as 'unitary' or 'one-tiered'. This is because the management/executives are usually also sitting on the board (dual chair). It is also common in Anglo-Saxon regimes to divide the board into 'insiders' and 'outsiders', based on their participation in running the company. Insiders are those board members that are also executives, while outsiders are the independent board members from outside the firm.

In contrast to the one-tier board system, the two-tier board system is common in Continental Europe, such as in Germany, Switzerland, Austria and the Netherlands. The two-tier board system comprises two boards: a supervisory board and a management board. Unlike in the one-tier board system, where the management can serve both as executive and director, the two-tier board system only allows an individual to serve either on the supervisory board or on the management board (Moerland 1995). In comparison to the Anglo-Saxon system, the supervisory board in the two-tier board system has a similar function to the BoD in the one-tier board system. However, only outsiders can sit on the supervisory board. As the supervisory board comprises the representatives of shareholders, board members are normally selected and dismissed by shareholders through the General Meeting of Shareholders (GMS). Further, this supervisory board appoints the management board, which is responsible for the firm's daily operations, including relevant decision making. Consequently, the management board has to report their duties and achievements to the supervisory board.

The effect of insiders on a board has been addressed in the literature with inconclusive results. Singh and Davidson (2003) argue that when insiders who are executives serve as board members, agency costs are likely to decrease, as these board members have a greater ability to align the interests of shareholders and management. This is because, in this case, the BoD is the representative of shareholders and therefore, as executives having dual roles, these board members are able to balance the interests of both parties. Complementing this finding, Ang, Cole and Lin (2000) contend that having outsiders on the board is likely to increase agency cost; while Hermalin and Weisbach (2003) believe that more outsiders (or a greater proportion of independent board member) is not strongly associated with firm performance.

By contrast, studies by Beasley (1996) and Uzun, Szewczyk and Varma (2004) found that having outsiders on the board is likely to decrease the occurrence of corporate fraud. These findings indicate that having outsiders on the board is important to maintaining effective corporate governance. Observations also show that there is an increasing trend in appointing outsiders to the board when firms experience poor stock performance (Kaplan & Minton 1994). Such an observation gives evidence that the role of outsiders has a positive impact on firm performance. Although research shows that outsiders could have a positive impact on the board's monitoring role and effectiveness, Johannisson and Huse (2000) argue that outsiders on the boards of family-type corporations have less of an impact on board effectiveness. This is because the controlling family tends to have a dominant influence over board member appointments, making the independence of outsiders questionable, as they may potentially collude with dominant shareholders (Johannisson & Huse 2000).

2.6.1.3. Board Meeting

Conger, Finegold and Lawler (1998) explored the importance of board meetings, which they view as a medium for board members to discuss the performance of management and other important issues of the company. This view implicitly indicates that frequent board meetings are likely to provide better monitoring of management and reduce potential conflicts. However, more frequent board meetings are also likely to hinder efficiency and monitoring efforts because they further shorten the operational time of the board members assigned to completing routine tasks (Conger, Finegold & Lawler 1998).

Zhender (2000, as cited by Carter and Lorsch 2004, p. 22) surveyed the amount of time spent by board members in 2000, finding that "the 'average' directors in North America and Europe spend around 100 hours or even less to their tasks (including time spent outside meetings on their own, gathering and reviewing information), with an average seven meetings a year". In support of this finding, Monks and Minow (2008) found that seven full board meetings in 2000 is a slight decrease in meeting frequency compared to in the 1990s. This is due to an increasing reliance on board committees' functioning.

In line with this argument, Clarke (2007) states that board members usually work intensely during the period around meetings because all required paper work and report need to be prepared and circulated before the meeting. Hence, the amount of time spent by individual board members is related to time spent on the preparation for meetings, rather than on the frequency or duration of board meetings.

2.6.1.4. Board Committees

The Cadbury Committee (1992) proposed that BoD should have subcommittees to help the board members identify the challenging areas of corporate governance with regard to financial reporting, directors' remuneration and board appointments. The OECD (2004) also suggests that BoD establish specific committees with non-executive members to help with financial reporting, nominations and executive remuneration where there are potential conflicts of interests. Thus, it is expected that the BoD should exercise independent judgment in tasks with the potential for a conflict of interests.

Monks and Minow (2008) argue that, based on observations, most companies have four or five board committees. However, having at least three committees, such as an AC, compensation committee and nominating committee, is an absolute requirement for proper functioning. In addition, companies could form an *ad hoc* committee relating to specific circumstance and need, such as for CEO succession (Monks & Minow 2008). Clarke (2007) argues that board committee members should include non-executive directors.

Although the establishment of board committees according to the Cadbury Committee recommendations is widely followed, the effectiveness of these board committees to improve corporate governance practices has not been adequately analysed (Spira & Bender 2004). Klein (1998) analysed the structure of board committees and the role of directors within these committees, finding that particular structure of special committee, such as percentage of inside directors within finance and investment subcommittees, is positively associated with company accounting and stock performance. Vafeas and Theodorou (1998) studied the relationship between structure of the BoD and firm value, including the fraction of independent (non-executive) directors serving as committee members, but inferred no significant links between board structure and firm performance.

Uzun, Szewczyk and Varma (2004) identified that various characteristics of BoD, including board committees, are significantly related to the occurrence of corporate fraud. Specifically, the establishment and existence of AC and compensation committees are closely related to the occurrence of fraud. However, within their sample, these authors found that the presence of a compensation committee actually increased the likelihood of fraud.

In connection with the existence of AC and firms' fraudulent activities, Beasley (1996) found that the presence of an AC did not significantly reduce the likelihood of fraudulent activities. Beasley et al. (2000) further studied the corporate governance differences between fraud and non-fraud companies, in particular for financial statement fraud, across three volatile industries: technology, healthcare and financial services. They found that non-fraud sample companies across industries have stronger corporate governance mechanisms relative to fraud sample companies. In particular, all fraud companies across the three industries had fewer independent AC members, less internal audit functioning and fewer independent board member in comparison to the non-fraud companies.

2.6.1.5. Board Expertise

Conger, Finegold and Lawler (1998) state that BoD members are similar to other knowledge workers within a corporation. Hence, members should have the same knowledge and capabilities as others employees in the corporation. Knowledge, information, power, motivation and time are the most important elements that board members should possess.

Pugliese and Wenstøp (2007) introduced the new terms of ‘board working style’ and ‘board quality attributes’ to address board attributes. They found that board working style and board quality attributes are more important determinants than board composition, as they foster board strategic involvement. Board quality attributes are based on knowledge, diversity and motivation, and they therefore strongly support the board in taking strategic measures.

Norburn (1986, as cited by Zahra & Pearce 1989) identified the BoD characteristics as directors’ earlier background, education, experience, beliefs and attitudes. Hillman et al. (2000) argue that previous research acknowledges the importance of the resources, experience and knowledge of both insider and outsider directors. Further, they state that although insiders may have firm-specific knowledge and valuable experiences, outsiders may also have additional functional knowledge (for example, accounting and finance knowledge) and general industry knowledge that supports board roles.

Recent literature by Jeanjean and Stolowy (2009) indicates a relationship between board members’ financial expertise and other corporate governance characteristics among French-listed companies. Financial expertise is measured by educational background and career experience. Board members’ financial expertise was found to be negatively associated with board type (whether ‘one-tier’ or ‘two-tier’), but positively correlated with other governance characteristics such as board independency, ownership concentration and institutional ownership. The French regulatory regime does not require listed companies to have board members with financial expertise, which further proves the importance of financial expertise for a good corporate governance mechanism (Jeanjean & Stolowy 2009). In the Taiwanese context, Chen, Elder and Hsieh (2007) argue that financial expertise of independent board members is negatively associated with the occurrence of earnings management. Hence, financial expertise is one important aspect of good governance practice.

2.6.2. Audit Committee

To perform its function to monitor management properly, the BoD has to be equipped with special knowledge and expertise to oversee management continually in all aspects, including in the financial and auditing areas, which underpin the financial reporting system for all shareholders. The financial area is the heart of the accountability process for business entities, as shareholders entrust their funds to a corporation to be managed properly by management. In return, shareholders expect their return through dividend payments and increases in their shares' market value.

The corporate governance principles (OECD 2004) encourage greater involvement of the BoD in company financial reporting processes and the monitoring of EA. As the BoD will not always have all the necessary knowledge and expertise in the specific areas they oversee, the board could form specific subcommittees with the specialist knowledge and expertise to help the board to fulfil its monitoring function. The corporate governance framework specifies the formation of subcommittees by the board, with the AC being one of the recommendations (Cadbury Committee 1992). Three major responsibilities of the AC are suggested: to oversee company internal control, ensure the integrity of company financial statements and coordinate all audit activities (Baker & Anderson 2010).

More specifically, the Blue Ribbon Committee (1999) has come to some recommendations about AC characteristics to increase its performance. First, similar to the independent nature of BoD members, the AC should include independent members. Second, to deal with auditing and financial complexity, AC members should have expertise and experience in auditing and finance. Third, the committee size has to be considered with a view to its effectiveness. Fourth, the activity of the AC is reflected through committee meeting frequency, where it is advised that regular meetings positively contribute to effective monitoring of management.

Further, DeZoort et al. (2002) provide some additional AC characteristics for its effectiveness, including composition, authority, resources and diligence. The authors adopt a cycle process to determine audit committee effectiveness (ACE), starting from input, process and output. The input stage comprises AC composition, authority and resource factors, while the process stage features the diligence factor. The expected output is ACE.

Recent literature by Ghafran and O'Sullivan (2012) summarises previous literature regarding ACE. Similar to the work by DeZoort et al. (2002), Ghafran and O'Sullivan (2012) categorise

AC characteristics into three components: composition, resources and diligence. In addition, the authors propose that external audit quality, financial reporting quality and internal audit quality are the output of ACE (Ghafran & O'Sullivan 2012). Bédard and Gendron (2010) also analyse the AC literature and categorise ACE into four broad dimensions: financial reporting, EA, internal control and investor perception.

Turley and Zaman (2007) take a different approach when conducting research on ACE. Instead of using quantitative characteristics as suggested by previous results, they measure the qualitative aspect of ACE through behavioural perspectives. The authors focus on the informal process and interaction between committee members, EA and internal control function. Then, using a case study approach, they conclude that informal networking between all participants, along with non-formal structure and process support, are the greatest advantages of ACE.

With regard to AC independency, there are two aspects to considers: the degree of independence of individual AC members and the proportion of independent members to total members (Bédard & Gendron 2010). Independent members refers to non-executive and non-related members. With regard to the non-related condition, three relationship conditions (employment, personal and business) should be avoided for a member to be categorised as not related (Bédard & Gendron 2010). For there to be no employment relationship, the AC member should not be currently employed by the corporation or have been employed in the last three years by the corporation (Blue Ribbon Committee 1999). No personal relationship means that the AC member should not have any family ties or friendships (current or historical) with the company management. A business relationship refers to the condition in which a member receives any fees or compensation from the company or its affiliates from undertaking any contract, business, consultation or advisory services.

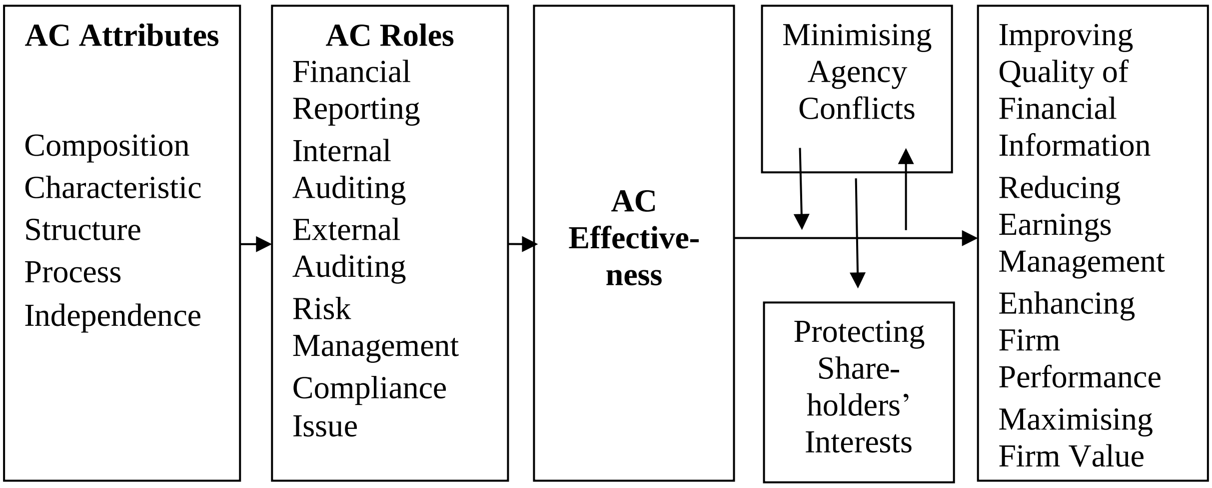
In relation to AC expertise, the Blue Ribbon Committee (1999) identifies at least three competencies that should be embedded within the committee. These competencies are financial literacy, financial expertise, governance expertise and other expertise. Financial literacy is the ability to read and understand a set of financial statements. The term financial expertise refers to financial literacy characteristics and experience in preparing audits and financial statements. Governance experience and other expertise refers to experience in other or previous AC roles, other directorships or knowledge about the internal control and operation of a company.

In addition to the above AC characteristics, AC mechanisms should be observed in parallel when determining ACE. These mechanisms transform all the required or best practice characteristics into output, and thus effectiveness. Bédard and Gendron (2010) identify six dimensions of AC mechanisms: agenda, meetings, questioning, relationship, power and leadership.

Sabia and Goodfellow (2005, as cited in Bédard & Gendron 2010) argue that the meeting agenda is an important tool for AC meetings to be deemed effective. In particular, the agenda serves as a reminder for its members about their specific responsibilities and the discussion topics. Meeting frequency reflects the time spent by AC members to perform their tasks and responsibilities. Theoretically, more meetings will result in better effectiveness. However, there is an optimum meeting frequency recommended by governance best practice, which is at least four times a year and more for larger public companies (Sabia & Goodfellow 2005, as cited in Bédard & Gendron 2010). Meeting frequency is one of the more easily observed AC mechanisms, as companies have to disclose their meeting frequency in their annual reports.

Although the AC has to be independent from management (that is, have no relationship with management), the effective mechanism actually relies on cooperation with management. In this case, cooperation means that the AC and management should be able to share information through outside or non-formal channels. This relationship-based sharing mechanism will improve the monitoring function of the AC. The power mechanism is related to the strength of the AC to be able to execute their demand or requesting improvements. This power usually derives from the chairperson figure or individual figure, or even the prestige of the AC as a whole. Finally, the leadership mechanism is embedded in the chairperson of the AC, and the leadership characteristic shapes overall AC performance.

Mohiuddin and Karbhari (2010) also reviewed the AC literature and summarise the ACE model as presented in Figure 2.2 below.



Source: Mohiuddin and Karbhari (2010, p. 112)

Figure 2.2 Audit Committee Effectiveness Model

2.6.3. External Auditor

The role of the EA in the corporate governance system is one of assurance. The sources of agency problems between shareholders (principal) and agents (management) are misalignment of interests between two parties because of time horizon differences, and the moral hazard problem because of information asymmetry between the two. Information asymmetry refers to the condition in which the amount of information regarding financial transactions is not equal between groups of investors (Watts & Zimmerman 1986). To minimise this information asymmetry, shareholders need to be assured that the information provided by management is objective and reliable. The EA, as an independent and professional institution of audit and assurance specialists, is the appropriate party to perform this assurance service, hired by shareholders as part of the monitoring activities undertaken.

As discussed above, a company's financial statements would presumably be biased towards management interests if there were no independent mechanism to verify the information provided by management. In this case, the EA should serve as an independent and credible institution to assure reliability and disclosure of financial statements prepared by management. By performing audit on these financial statements, the EA lends its credibility to shareholders and stakeholders to assure them that financial statements are reliable, thereby alleviating agency problems (Rezaee 2004). In addition, although the BoD and auditor are the frontline to protect the public from management fraud in financial reporting, the BoD has to rely predominantly on the EA to ensure that financial statements are in accordance with accounting standards and fairly reflect the actual condition of a company's finances (Baker & Anderson 2010).

Managers have the incentive to minimise the costs associated with information asymmetry by disseminating the information that they possess and appointing an EA for audit purposes (Akerlof 1970). In addition, recent accounting and corporate scandals such as Enron in 2001 triggered questions about the quality of EA. Quality of audit refers to the joint probability that an EA could detect any misstatement in the financial statements and reveal the situation to users of the financial report. The probability to detect misstatement is affected by auditor competency and experience, while the probability to reveal depends on auditor independence; that is, the auditor's willingness to take risks, and handling pressure from management (DeAngelo 1981a, 1981b).

The independence of EA issue has become a crucial factor in audit quality because, as a professional accounting firm, the EA has to be independent, both 'of mind' and 'in appearance'.[1] However, Abdel-Meguid, Ahmed and Duellman (2011) argue that this independent nature of the EA is sometimes compromised because of its economic dependence on clients. Mautz and Sharaf (1961, as cited in Abdel-Meguid, Ahmed and Duellman 2011) identify this economic dependence as a 'built-in anti-independence factor'. Further, expectations of being hired in the future (economic motive to receive potential fees) by existing clients will likely compromise auditor independency (DeAngelo 1981b).

With respect to corporate governance, the quality of external auditing is crucial to support good corporate governance practices. DeAngelo (1981b) introduces accounting firm size as a proxy for auditor quality (auditor independence). The rationale behind this proxy is that because big sized auditor firms do not depend on single or a few clients, and therefore are not afraid of losing clients if they have to disclose any misstatement to maintain their integrity, they are free from economic motives.

After the wave of corporate scandals in the 2000s, especially the Enron case, there are only four big accounting firms (the 'Big 4') across the globe. These accounting firms are usually referred to as the Big 4 auditors, and become a proxy for quality EA in auditing and corporate governance (Hakim & Omri 2010). Further, the Big 4 accounting firms provide a higher

[1] See Accounting Professional & Ethical Standards Board (APESB) 2010, 'APES 110 Code of Ethics for Professional Accountants'.

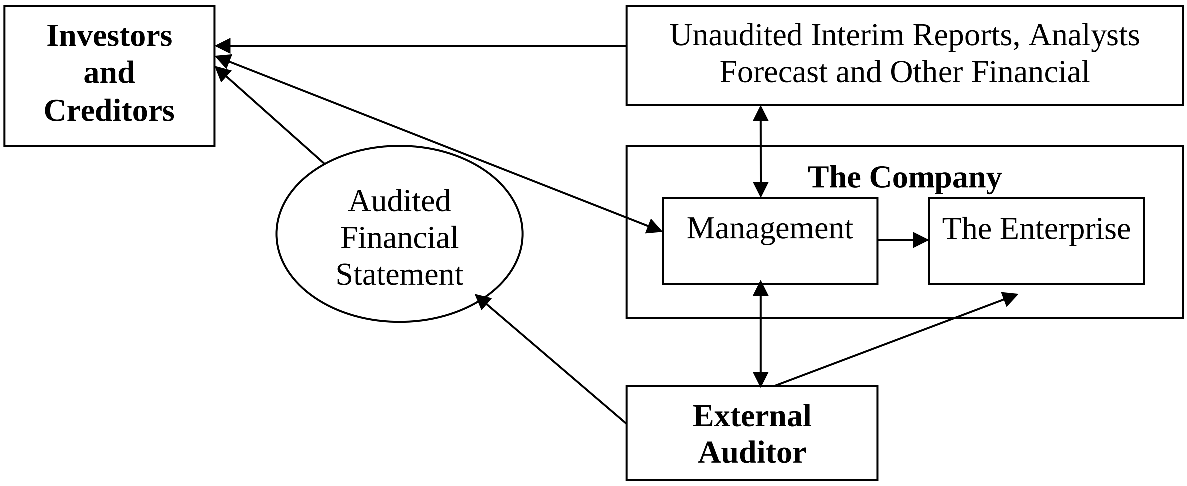
quality of auditing service because they have greater in-house experience and expertise in the auditing area (Francis & Yu 2009).

In the case of emerging markets, where high concentration of ownership is prevalent, the role of the EA and its quality is more complicated. In this situation, the source of the agency problem is primarily controlling and minority shareholders' conflicts. On the one hand, controlling shareholders can more easily extract private benefits of control at the expense of minority shareholders. Controlling shareholders would be, in this case, unconcerned about the quality of EA, as they have obtained private benefits. On the other hand, expropriation by controlling shareholders will come at a cost to minority shareholders and potential investors. Future investors will value this expropriation practice by discounting company share price, avoiding buying company shares or refusing to give the company a loan in the future. Therefore, controlling shareholders will calculate their costs and benefits and decide which EA (in terms of quality) to hire. If the cost of expropriation is greater than its benefit, the controlling shareholders will then mitigate the agency problem by employing a high quality EA to attract and assure potential investors (Fan & Wong 2005).

Baker (2009) reviewed the development of EA roles in corporate governance. The current accepted model of the EA role is to assure the fairness and reliability of financial statements for every fiscal year end period. However, this role has two significant problems. First, the audited financial statement as per its conceptual theory only reflects the historical financial condition of the company and not its current economic 'reality', which is the most critical information needed by shareholders and wider stakeholders. Second, the EA, limited to some certain extent, is under company management influence. As the auditor has to gain access to company accounting records and documentation, they have to cooperate with management to a certain degree, which could compromise their independency. Further, it is possible that management could select certain records and documentations to open to the auditor, without the realisation of the auditor; this situation is an audit risk (Baker 2009).

Baker (2009) argues that the current accepted role of EA does not reflect the actual role of auditing in corporate governance. Audited financial statements are produced some time after the end of the reporting period, and they thus reflect the historical financial condition of the company. In relation to the investment decision-making process by shareholders or potential investors and even wider stakeholders, Baker (2009) challenges that audited financial reporting only plays a limited support. This is because other financial information resources, such as unaudited interim earnings announcements, analyst forecasts and other private financial information by management are becoming the first source of information to be considered for decision-making purposes, on top of traditional audited financial statements (Williams 1996, as cited in Baker 2009). Based on this condition, Behets (1998, as cited in Baker 2009) suggests that audited financial statement will soon be obsolete. Hence, this raises questions about the role of the EA in corporate governance.

Figure 2.3 shows the actual role of the EA in corporate governance.



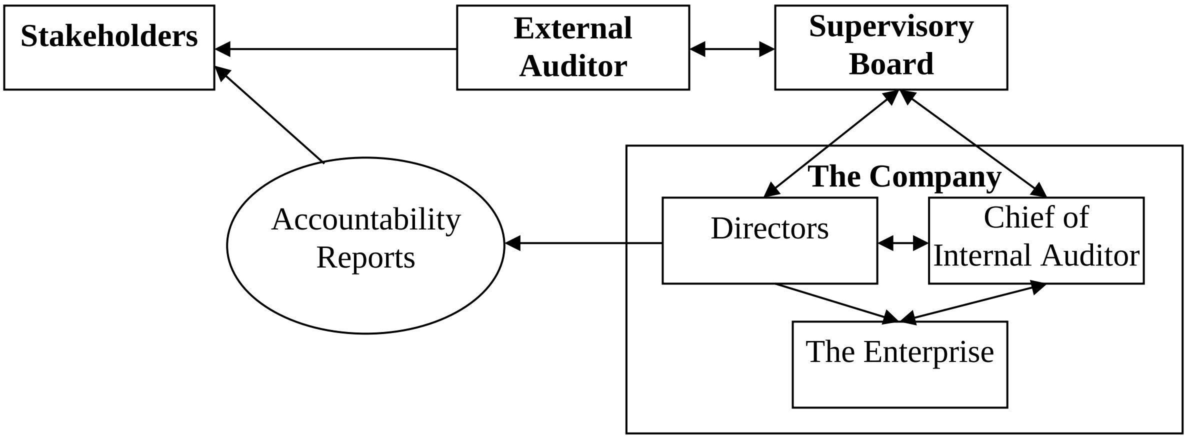
Source: Baker (2009, p. 28)

Figure 2.3 Actual Model of the External Auditor Role

To overcome these challenges, Baker (2009) proposes that the EA should play a new role in corporate governance. Instead of only assuring financial statements and serving shareholders' interests, the EA should serve wider stakeholder interests. In accordance with the arguments of the Institute of Chartered Accountants in Scotland, the author proposes that the EA provide assurance: 1) of the reliability of financial statements, 2) that the company will not fail, 3) that no existing fraud has been detected, 4) that the company complies with law, 5) that the company has been managed competently, and 6) that the company adopts socially and environmentally responsible behaviour (Baker 2009).

This proposed new role of the EA in corporate governance will drastically change current corporate governance standards and practice. A strong internal audit function should be embedded within the company. Then, it is the EA's responsibility to ensure that management has undertaken appropriate actions to assure the six areas given above. In performing this new assurance function, the EA should work closely with the supervisory board.

Figure 2.4 reflects the new role of the EA in corporate governance.



Source: Baker (2009, p. 30)

Figure 2.4 The New Role of the External Auditor in Corporate Governance

2.7. Effectiveness of Corporate Governance—Empirical Studies

2.7.1. Corporate Governance and Agency Costs

According to the agency theory, corporate governance should minimise agency costs. Ang, Cole and Lin (2000) studied the relationship between corporate OS and agency costs in small businesses in the US. They concluded that managerial ownership has a relationship with agency cost. Specifically, they found that outsider-managed firms have higher agency costs in comparison to owner-managed firms for small businesses. Extending this research, Singh and Davidson (2003) studies large businesses in the US. They concluded that insider managerial ownership reduces agency conflicts between shareholders and management in large corporations.

Claessens and Fan (2002) studied the corporate governance implementation in Asia. One of the results showed that monitoring mechanisms, as part of corporate governance practices, are considered ineffective and inefficient. Therefore, the controlling owner/manager has to bear the agency costs in terms of discounted share prices by the market.

2.7.2. Corporate Governance and Firm Performance

Gibson (2003), Brown and Caylor (2006), Chuanrommanee and Swierczek (2007), Alijoyo et al. (2004), Epps and Cereola (2008), Klapper and Love (2004) and Bhagat, Bolton and Romano (2008) examined the effectiveness of corporate governance towards firm performance. Using a corporate governance rating, Bhagat, Bolton and Romano (2008) concluded that there is no consistent relationship between corporate governance indices (as a proxy for governance quality) and firm performance. Further, they argue that the effectiveness of corporate governance will depend on the firm context and firm-specific circumstances.

Chuanrommanee and Swierczek (2007) questioned whether the effectiveness of corporate governance for firm performance in Asia is a reality or illusion. Based on the rating given by Credit Lyonnais Securities Asia, they found that company documentation of corporate governance does not necessarily reflect actual conditions, and practices adopted do not affect company performance. Therefore, they argued that corporate governance in Asia is more of an illusion than a fact.

As the studies linking corporate governance and firm performance are inconclusive, it is further argued that corporate governance best practice recommendations are only intended to protect shareholders' interests and maximise the long-term value of shares, not necessarily to improve company performance and align with strategic company priorities (Baker & Anderson 2010, p 67).

2.7.3. Corporate Governance and Disclosure

Studies evaluating the relationship between corporate governance and quality of company reporting have also returned mixed results. Wright (1996) analysed financial reporting quality and its relationship with corporate governance attributes. He found that the presence of insiders within AC ('grey directors') is negatively correlated with financial reporting quality. He also stated that the role of the AC in monitoring company reporting quality also depends on firm OS.

Karamanou and Vafeas (2005) argue that firms with more independent board members and smaller AC size are positively associated with voluntary financial disclosure. Voluntary financial disclosure refers to the issuance of management earning forecasts prior to actual results, meaning that management disseminate more information to shareholders to minimise information asymmetry. Karamanou and Vafeas (2005) conclude that there is empirical evidence to support the positive association between effective corporate governance and higher financial disclosure quality.

However, studies by Koehn and Ueng (2005), Farber (2005) and Myring and Shortridge (2010) give different results. Koehn and Ueng (2005) revealed that corporations with weak governance practices provide financial information that is as good as that of firms with strong governance attributes. Recent research by Myring and Shortridge (2010) argues that good corporate governance will not always result in good quality financial statement information. Using corporate governance ratings from the Corporate Library, they find mixed evidence to support these relationships.

2.7.4. Corporate Governance and Firm Value

Other scholars (for example, Gompers, Ishii & Metrick 2003; Brown & Caylor 2006; Bebchuk, Cohen & Ferrell 2009) studied the relationship between corporate governance and firm value. Gompers, Ishii and Metrick (2003) measured the corporate governance practices using the G-Index, a measurement of 24 firm-specific provisions, and found that more democratic firms are more valuable. Brown and Caylor (2006) also formulated a Gov-Score, a broad measurement of corporate governance practices based on 51 firm-specific provisions representing both internal and external governance, and found that seven provisions underlying Gov-Score are fully related with firm value. However, Bebchuk, Cohen and Ferrell (2009) constructed an entrenchment index (E Index) based on six provisions, determining these provisions to be negatively correlated with firm valuation.

2.8. Corporate Governance and the Incidence of Fraud/Sanctions

The study of the relationship between corporate governance and occurrence of fraudulent activities also interests many researchers (for example Beasley 1996; Uzun, Szewczyk & Varma 2004; Lo, Wong & Firth 2010; Persons 2005, 2006; Bourke 2006; Chen et al. 2006; Bourne 2008; Jia et al. 2009; Abdelsalam & El-Masry 2008; Mangena & Chamisa 2008; Ezat & El-Masry 2008). Beasley (1996) studied whether style and form of corporate governance help to deter financial fraud in the US and found that higher proportion of outsiders in the BoC reduces the likelihood of financial statement frauds. Uzun, Szewczyk and Varma (2004) examined the occurrence of US corporate fraud for the period 1978–2001 based on various characteristics of the BoD, arguing that board characteristics (that is, composition and structure of board oversight committee) are significantly correlated with incidence of firm fraud. Their findings also showed that a greater number of independent outside directors on a board and on the AC and compensation committee decreases the likelihood of corporate fraud. Bourne (2008) analysed the inclusion of a corporate governance index in the financial ratios formula as a predictor for fraudulent financial reporting. His findings show that the inclusion of Brown and Caylor's (2006) corporate governance index (Gov_Score Index) with financial ratios provides a statistically significant model predictor for fraudulent financial reporting (Bourne 2008).

The effect of new corporate governance rules and the likelihood of fraudulent financial reporting is also examined by Persons (2005). Based on corporate governance characteristics, the author states that the likelihood of financial statement fraud is lower when the firm's AC is solely comprised of independent directors, and when the AC's members have fewer directorships with other companies. Moreover, Persons argues that BoD independence, AC expertise and nominating committee independence are not significant in reducing the likelihood of financial fraud. Similar research by Bourke (2006) reveals that most corporate governance attributes are significantly related to the occurrence of fraudulent financial reporting in US-listed firms; these attributes include BoD independence, the dual roles of CEOs and board chairs, and share ownership by outside block-holders.

In relation to earnings management, Prencipe and Sason (2011) research the relationship between independency of the BoD and the occurrence of earnings management in the family-controlled company environment. Previous literature has shown that an independent BoD will likely reduce the occurrence of earnings management in widely held public companies. However, this is not the case with family-controlled companies, where there is a high risk of collusion and the independency of the board is questionable. The authors find evidence that the impact of independent board members in family-controlled corporations towards the occurrence of earnings management is less significant compared to in widely held companies. (Prencipe & Sason 2011).

With regard to the occurrence of transfer pricing for related party transactions, Lo, Wong and Firth (2010) investigated the corporate governance structure that constrains the opportunistic behaviour of management in manipulating transfer pricing. They found that certain governance structures such as higher percentage of independent directors, lower percentage of parent directors, different people occupying the chair and CEO roles and the existence of financial experts on the AC, reduced the likelihood of transfer pricing manipulation. They concluded that quality of corporate governance is important to deter transfer pricing manipulation. Similarly, Yeh, Shu and Su (2012) found that level of related party transactions is negatively correlated with corporate governance quality in Taiwan.

In relation to the timelines of reporting for listed companies, Abdelsalam and El-Masry (2008) and Ezat and El-Masry (2008) studied the impact of corporate governance on reporting timeliness among Irish- and Egyptian-listed companies. The studies find that in Irish-listed companies, BoD independence and CEO ownership had a positive association with reporting timeliness, whereas in Egyptian-listed companies, especially in the service industry, more independent directors, larger number of directors and dispersed ownership showed a positive impact on timely reporting.

Persons (2006) also examined the likelihood of non-financial reporting fraud as a result of the implementation of corporate governance. Typical types of non-financial reporting fraud include defrauding of consumers, defrauding of government and violation of regulations. The author argues that non-financial reporting fraud affects broader stakeholders, such as customers and the government, rather than only shareholders, as in the case of financial reporting fraud. Hence, Persons (2006) suggests that non-financial reporting fraud would produce at least equal weight in magnitude in comparison to financial reporting fraud. The study reveals that the probability of non-financial reporting fraud is lower when these conditions are met: larger proportion of outside independent directors, different people in CEO and BoD chair roles, smaller BoD size, longer tenure for BoD chair and higher firm profits.

In China, Jia et al. (2009) examined the relationship between the roles of the supervisory board and the incidence of enforcement actions by the regulator and stock exchange. They concluded that the supervisory board has a significant role when Chinese public companies face enforcement actions. Further, they stated that in China the supervisory board is ineffective, contrary to its theoretical role. A larger supervisory board and more frequent supervisory board meetings are positively associated with more severe sanctions imposed by the regulator or stock exchange. Chen et al. (2006) studied whether OS and board characteristics have an impact on corporate financial fraud in China. They found that board characteristics, especially proportion of outside directors, number of board meetings and length of tenure of Board chair, are more important than OS.

Mangena and Chamisa (2008) also studied the relationship between corporate governance structure under the Anglo-Saxon regime for developing countries and the incidence of listing suspensions by the Johannesburg Stock Exchange, South Africa. They found that smaller proportion of non-executive directors, the non-existence of an AC, greater block-share ownership and higher leverage (debt) increases the incidence of listing suspensions. However, they reported no association with board size, role duality, directors' share ownership, auditor quality or return on assets.

A study by Da Silva Rosa, Filippetto and Tarca (2008) analysed the relationship between enforcement actions and firms' corporate governance structures using the enforcement actions taken by the Australian regulator (Australian Securities and Investment Commission—ASIC) on targeted firms. The findings showed that firms being investigated by ASIC have weaker corporate governance scores compared to other contemporary companies similar in size and industry. They also argued that companies with lower performance (low profitability) tend to violate rules and regulations. This concurs with the argument that firms under pressure because of poor performance are more likely to adopt aggressive accounting policies and be less transparent. This study concluded that the Australian capital market regulator performs effectively in recognising possible breaches by companies that have lower corporate governance status.

Recent research by Law (2011) examined the corporate governance attributes in relation to the absence of fraud in organisations in Hong Kong. The findings infer that AC, internal audit function, concern of top managers, and ethical guidelines within firms are positively associated with the non-occurrence of fraud. No evidences have been found to show that auditor type and audit report are associated with the absence of fraud (Law 2011).

Table 2.2 provides a summary of the literature discussed in this chapter organised by focus. A more detailed summary of the literature is provided in Appendix A of this thesis.

Table 2.2 Summary of Main Literature

Literature Focus	Summary of Conclusion
Corporate Governance—Conceptual Theory Jensen and Meckling (1976), Fama (1980), Fama and Jensen (1983), Hart (1995), Franks and Mayer (1996), Shleifer and Vishny (1997), Davis, Schoorman and Donaldson (1997), Kabir, Cantrijn and Jeunink (1997), La Porta et al. (1998), La Porta, Lopez-de-Silanes and Shleifer (1999), Weimer and Pape (1999), Jenkinson and Ljungqvist (2001), Denis and McConnell (2003)	The separation of ownership and control in the modern corporation has created conflicts between shareholders and management. Corporations are also viewed as the nexus of contracts, and incomplete contracts will always exist within the corporation. External forces have sometimes failed to create efficient markets and, therefore, effective corporate governance principles are needed to alleviate agency conflicts and cover incomplete contracts to protect shareholders' interests.
Corporate Governance—Ownership Concentration Claessens, Djankov and Lang (2000), Tabalujan (2002), Faccio and Lang (2002), Holderness (2009)	Corporations in the western economies exhibit widely dispersed ownership structures, while ownership of corporations in most Asian countries is concentrated within a family or small group. However, recent findings have challenged the widely dispersed ownership structure in the US, arguing that the concentrated ownership structure is more prevalent than previously thought.
Corporate Governance and Agency Cost Ang, Cole and Lin (2000), Claessens and Fan (2002), Singh and Davidson (2003)	Corporate governance practices have an impact on agency costs. Specifically, managerial ownership contributes to lower agency costs. In addition, monitoring mechanisms are considered ineffective and inefficient in Asia. Therefore, controlling owner/manager has to bear agency costs in terms of discounted share price in the market.
Corporate Governance and Firm Performance Xu and Wang (1997), Gibson (2003), Klapper and Love (2004), Alijoyo et al. (2004), Brown and Caylor (2006), Chuanrommanee and Swierczek (2007), Epps and Cereola (2008), Bhagat, Bolton and Romano (2008), Nuryanah and Islam (2011)	The effect of corporate governance implementation on firm performance is inconclusive. Studies have found no consistent relationship between corporate governance and firm performance. In most Asian economies, corporate governance implementation is merely an illusion and does not have any impact on performance.

Literature Focus	Summary of Conclusion
Corporate Governance and Disclosure Wright (1996), Karamanou and Vafeas (2005), Farber (2005), Koehn and Ueng (2005), Myring and Shortridge (2010)	The effect of corporate governance implementation on firm disclosure is inconclusive. The literature argues that the presence of independent board member and an audit committee improves company disclosure. However, there is no significant difference in disclosure quality between companies displaying strong or weak corporate governance implementation.
Corporate Governance and Firm Value La Porta et al. (2002), Gompers, Ishii and Metrick (2003), Brown and Caylor (2006), Bebchuk, Cohen and Ferrell (2009)	Most literature supports corporate governance implementation having a positive effect on firm value as measured by market capitalisation. Democratic firms, with good protection for shareholders' rights, have a better stock price and hence firm value. Firms in countries with strong investor protection rights are also valued higher.
Corporate Governance and the Incidence of Fraud/Sanctions Beasley (1996), Uzun, Szewczyk and Varma (2004), Persons (2005, 2006), Bourke (2006), Chen et al. (2006), Abdelsalam and El-Masry (2008); Mangena and Chamisa (2008), Donker and Zahir (2008), Ezat and El-Masry (2008), Da Silva Rosa, Filippetto and Tarca (2008), Bourne (2008), Jia et al. (2009), Lo, Wong and Firth (2010), Warren et al. (2011)	There is a relationship between corporate governance and the incidence of fraud/sanctions. Corporate governance implementation was measured using some attributes, such as ownership structure and board characteristics. The incidence of sanctions/fraud consists of fraudulent activities, financial and non-financial reporting and timeliness of report submissions. The literature argued that corporate governance implementation has a positive effect in reducing the likelihood of fraud/sanctions.

2.9. Summary

This chapter discussed the basic theories of corporate governance and its implementation into corporations' structure and practices. The conceptual theories of corporate governance were addressed by looking into four basic models: the finance model, stewardship model, stakeholder model and political model. In each model, there are relationship and behaviour problems between shareholders, management and other stakeholders in the corporations. However, each model takes a different perspective on analysing those relationships and behaviours among participants.

The application of the corporate governance concept around the world depends on country characteristics. Weimer and Pape (1999) devised an international corporate governance taxonomy, grouping countries as following an Anglo-Saxon, Germanic, Latin or Japanese pattern. As the importance of corporate governance has been recognised worldwide, there is agreement that corporate governance guidance is necessary. This effort started with the introduction of the UK's Cadbury Code in 1992, followed by the issuance of the OECD's Principles in 1999 and 2004. The OECD Corporate Governance Principles have become international best practice among OECD member counties and non-member countries alike.

How corporate governance principles are implemented into a firm is affected by two major factors, the internal and external mechanisms. Internal mechanisms include the firm's OS, BoD composition and executive remuneration, while the external mechanisms are market for corporate control and legal family origin. Corporate governance principles are also elaborated into practice through the characteristics of the firm, as seen in its BoD, AC and EA.

The implementation of corporate governance should affect firm performance. Extensive empirical studies focus on the effectiveness of corporate governance implementation. In general, the areas of corporate governance effectiveness are measured by firms' agency costs, financial performance, disclosures and firm values. Few studies have researched the effectiveness of corporate governance towards the incidence of fraud or sanctions.

The next chapter will discuss the regulatory framework and corporate governance situation in Indonesia, including the legal system, corporate governance code and regulations, and enforcement actions in the Indonesian capital market. This chapter provides background on Indonesian corporate governance, to assist in meeting the research objectives.

Chapter 3: Regulatory Framework and Corporate Governance in Indonesia

3.1. Introduction

To understand the regulatory framework in Indonesia better, this chapter will briefly explain the major Indonesian legislation that affects corporations and corporate governance implementation. Related institutions such as the regulator and the stock exchange will also be discussed in relation to their roles in monitoring and enforcing corporate governance practices in Indonesia.

3.2. The Indonesian Legal System and Institutional Framework

3.2.1. Company Law

The fundamental legislation that regulates corporations in Indonesia, like in other countries, is Company Law. During Dutch colonisation in Indonesia in the 1600s, there was only one law governing corporations: the Commercial Code 1847, based on the Civil law system. This Commercial Code was still in effect in Indonesia in 1995 when Indonesian Company Law was regulated through the Law of the Republic of Indonesia No. 1 of 1995: Limited Liabilities Companies. More recently, this 1995 Company Law was revised with a new act: the Law of the Republic of Indonesia No. 40 of 2007: Limited Liabilities Companies. This revised law has been in effect since it was enacted on 16 August 2007 (The Republic of Indonesia 2007).

The Indonesian Company Law of 2007 differentiates between an open company ('Perusahaan Terbuka') and a public company ('Perusahaan Publik') for the purpose of the capital market field.[2] An open company is defined as a public company or company that makes a public offering of shares in accordance with the provisions of legislative regulations in the field of capital markets. A public company is characterised as a company that fulfils the criteria of number of shareholders and amount of paid up capital in accordance with the capital market provisions.

[2] Indonesian Company Law is mostly focused on general corporations, and does not specifically address public/open companies in Indonesia.

The definition of public company accommodates circumstances for companies that have not offered shares through a public offering processes, but have met the criteria of number of shareholders and paid up capital, as specified in the Capital Market Law. The Capital Market Law stipulates that a company having at least 300 shareholders and a paid-in capital of at least three billion Rupiah will be considered a public company. This definition is intended to protect shareholders' interests (at least 300 shareholders) where they have invested in a company's shares despite them not having been issued through a public offering process.[3]

The open company definition would include public companies and other companies that make public offerings through the initial public offering (IPO) mechanism to the public. Open companies' names take the suffix 'Terbuka' (usually abbreviated as 'Tbk'), which means 'open'.

Indonesian Company Law requires corporations to have three important organs: GMS, a BoC and a BoD. In terms of the corporate governance taxonomy discussed in Section 2.3, Indonesian Company Law is based on the Civil law system and it adopts a Germanic two-tier board system.

The GMS is the highest level of authority within a company, at which BoC and BoD members are elected. The GMS is the only authority deciding strategic matters for corporations, such as articles of incorporation, mergers, acquisitions and bankruptcy declaration.

The two-tier board system comprises a BoC ('Dewan Komisaris') and BoD ('Dewan Direksi'). The BoC is similar to a BoD in the Anglo-Saxon/one-tier board system, and functions as a supervisory board. A BoD is equivalent to the executives/management responsible for daily operations. When comparing between the one- and two-tier systems, the terms BoC and BoD can be confounding. Thus, extra care should be taken when reading and interpreting these terms.

Indonesian Company Law states that the BoC has the responsibility to supervise and advise directors on strategic matters and operational overview, whereas the BoD takes decisions for

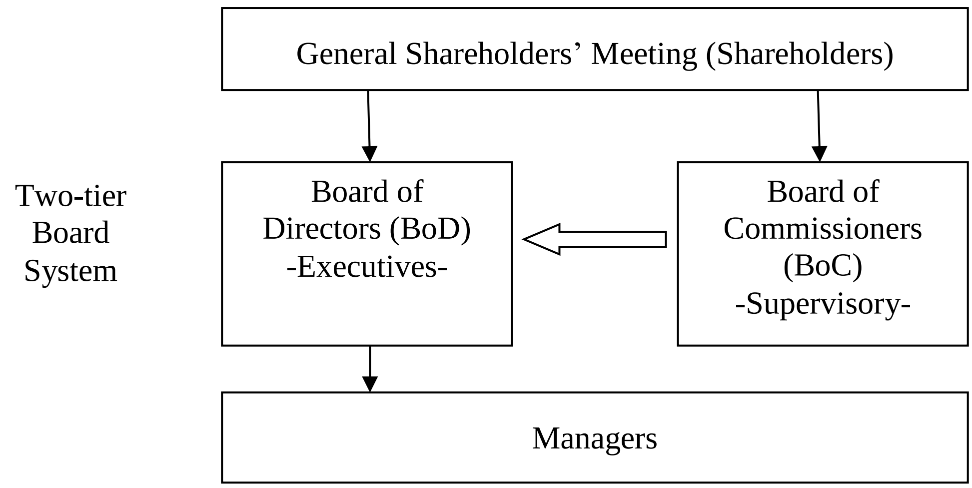
[3] In Indonesia, this situation usually refers to a membership-based company, such as a company that offers members to join business services by paying a certain amount of money, in return for which they will also get shares of the company. Thus, if the company has 300 members or more, and the company's paid-in capital is at least three billion Rupiah, this company will automatically be categorised as a public company. Therefore, they have to register to the regulator and follow all capital market regulations.

daily business activities and the operation of the company. The law also requires that BoC members perform in good faith, prudence and responsibility the tasks of supervising and giving advice to the BoD, and BoC members must exercise prudence in the interests of the company and in accordance with the company's purpose and objectives (article 114).

Moreover, the BoC should have at least one independent member and should establish at least one committee to help the BoC to perform its duties. These committees are solely responsible to the BoC, and their membership should include at least one BoC member for each committee.

Indonesian Company Law specifies that corporations that have issued shares to the public, collected public funds through its products or services, or managed public funds or assets should have at least two directors. In addition, the BoD has fiduciary duties and is liable for any negligence.

The general structure of a typical company in Indonesia is shown in Figure 3.1 below.



Source: Author summary from Law of the Republic of Indonesia No. 40 of 2007: Limited Liabilities Companies

Figure 3.1 Structure of Indonesian Company

3.2.2. Capital Market Law

With regard to capital market activities, Capital Market Law is the foundation regulation as a complement to Company Law. This regulation was stipulated through the Law of the

Republic of Indonesia No. 8 of 1995: The Capital Market, in force since 1 January 1996 (The Republic of Indonesia 1995c).

Indonesian Capital Market Law regulates aspects of capital market activities and its infrastructure. The law states that the Capital Market Supervisory Agency (‘Bapepam’),[4] an agency under the Ministry of Finance, is the capital market regulator in Indonesia. However, based on Minister of Finance Decree Number 606/ KMK.01/2005, dated 30 December 2005, Bapepam merged with the Directorate General of Financial Institutions (‘DJLK’),[5] into one new organisation named the Capital Market and Financial Institutions Supervisory Agency (‘Bapepam-LK’).[6] This new institution is also under the Ministry of Finance and is intended to supervise and control the non-bank financial services sectors including the capital market field.

The Capital Market Law administers the regulatory and institutional landscape for the Indonesian capital market industry. This landscape consists of Bapepam-LK as the regulatory body; self-regulatory organisations (SROs), including the stock exchange, clearing agency and depository institution as the pillars of capital market infrastructure; and market participants, such as public companies, securities companies, investment funds and the public. The Law also regulates some aspects of the corporate governance mechanism in the capital market industry, such as the reporting and auditing process, transparency requirements and sound market behaviour (for instance, the prohibition of insider information and insider trading, giving misleading information and market manipulation).

Further elaboration of the Capital Market Law is stipulated through Government Regulation No. 45/1995: Capital Market Activities (The Republic of Indonesia 1995a). This government regulation details the general procedures for any capital market activity, such as licensing, registration and approval procedures. This regulation is focused on the establishment of the fundamental infrastructure of the Indonesian capital market, including by specifying how to obtain a license as a stock exchange, settlement agency, custodian central, securities and investment company.

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[4] Bapepam is an Indonesian acronym for ‘Badan Pengawas Pasar Modal’, meaning the Capital Market Supervisory Agency.

[5] DJLK is an Indonesian acronym for ‘Direktorat Jenderal Lembaga Keuangan’, meaning the Directorate General of Financial Institutions.

[6] Bapepam-LK is an Indonesian acronym for ‘Badan Pengawas Pasar Modal dan Lembaga Keuangan’, a combined acronym between Bapepam and DJLK as a result of these organisations’ merger. ‘Badan Pengawas Pasar Modal dan Lembaga Keuangan’ translates as Capital Market and Financial Institutions Supervisory Agency.

Bapepam-LK as regulator issues rules and regulations to clarify the requirements on every aspect of capital market activity. These rules and regulations are updated regularly to adjust to meet economic and market conditions and to follow international best practices such as corporate governance principles.

3.2.3. Regulator/Authority

3.2.3.1. Capital Market and Financial Institutions Supervisory Agency

The Indonesian Capital Market Law specifies Bapepam as the agency responsible for the guidance, regulation and day-to-day supervision of the Indonesian capital market. This agency has to report to the Minister of Finance. However, because of merger, a new combined organisation, the Capital Market and Financial Institutions Supervisory Agency, or Bapepam-LK, has come into force since 30 December 2005.

The main task of Bapepam-LK as regulator is to ensure that the Indonesian capital market is running in an orderly, fair and efficient manner. In addition, the regulator should protect the interests of the public and investors (article 4). To achieve this objective, the law gives Bapepam-LK the authority to grant company business licenses to operate within capital market areas, special capital market licenses for individuals to perform professional services and approval for banks to be custodian banks.

In addition, the regulator has to oversee the public offering process and subsequent activities by public companies, and promote sound business practices based on various regulations, standards and codes. They also have to inspect and investigate any suspicious activities among capital market participants.

Bapepam-LK is also responsible for regulating market conduct, establishing accounting and auditing standards and promoting good corporate governance implementation for all market participants. The agency has accommodated the corporate governance code issued by Indonesia's NCG into rules and regulations. This approach makes most corporate governance principles compulsory, especially for listed companies in the capital market area. Moreover, Bapepam-LK's rules and regulations are often duplicates with the provisions of Company Law. This duplication is intended for enforcement practicality, as the inclusion of Company Law provisions into Capital Market Law creates a direct authority for Bapepam-LK to enforce those provisions (World Bank & IMF 2010).

The latest development in the Indonesian capital market regulatory framework is the establishment of an integrated financial sector supervisor, known as the Financial Service Authority ('Otoritas Jasa Keuangan' or 'OJK').[7] This new financial regulatory regime is regulated under the Law of the Republic of Indonesia No. 21 of 2011: Otoritas Jasa Keuangan, enacted 22 November 2011 (The Republic of Indonesia 2011).

Based on this new law, the regulator and supervisors of capital market and financial institutions (bank and non-bank) will be supervised by the OJK as a single supervisor. The OJK is an independent body, which means it will not be structured under any government ministry, and will report directly to the House of Representative and obtain funding from industry levies.

As the development of this new organisation is a complex task, the process of OJK formation has taken place gradually. This began with the transfer of capital market and non-financial supervision from Bapepam-LK to OJK at the end of 2012, followed by the transfer of banking supervision authority from the central bank (Bank Indonesia) to OJK by the end of 2013. By the beginning of 2014, the OJK is fully functional.

3.2.3.2. The Indonesian Stock Exchange

The history of the Indonesian Stock Exchange, established in 1912, can be traced to the Dutch colonial era (Indonesia Stock Exchange 2012). The Batavia Stock Exchange[8] was originally set up for Dutch companies to accommodate their business activities in Indonesia. The development of this exchange was negligible due to the effects of World War I, World War II, Indonesia's war for independence and the government transition from Dutch colonial rule to an independent Indonesian government. Finally, on 10 August 1977, the Jakarta Stock Exchange (JSX) was re-activated under the management of the government agency Bapepam.[9] This date is marked as the beginning of the Indonesian capital market, and is commemorated every year by the capital market industry. However, the trading activity of the stock exchange did not increase significantly until the late 1990s, when the Indonesian government introduced a policy to allow trading of foreign funds, and by foreign investors.

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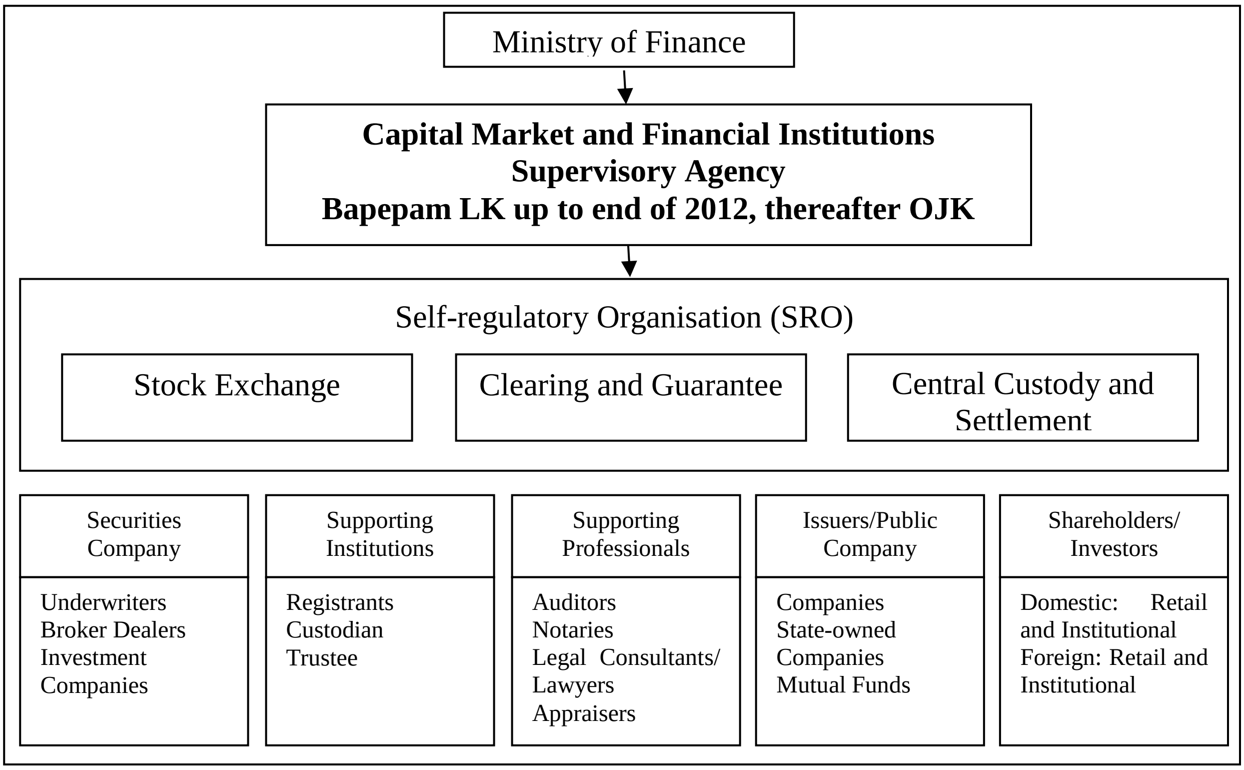
[7] OJK is an Indonesian acronym for 'Otoritas Jasa Keuangan', meaning Financial Service Authority.

[8] Batavia is the old name of Jakarta, the capital city of Indonesia during the Dutch colonial era.

[9] Bapepam at the beginning of its establishment was also responsible for establishing capital market industry, such as managing Jakarta Stock Exchange. It is not until 1992 when Jakarta Stock Exchange was privatised and Bapepam is solely responsible for supervisory function, not managing the exchange anymore.

The 1990s onward is thus seen as the boom period of the Indonesian capital market industry. To anticipate rapid market development, another stock exchange, the Surabaya Stock Exchange (SSX), was opened as a private exchange corporation.[10] Following this development, in 1992, the JSX was privatised, discharging Bapepam's responsibility for managing the exchange. In December 2007, the JSX and SSX were merged into one organisation, a Jakarta-based exchange named the Indonesian Stock Exchange (IDX).

The Capital Market Law stipulates that an exchange should provide the system and facilities for market participants as members to buy or sell their stocks. Moreover, the stock exchange has been given authority to administer regulations to its members and enforce those regulations to maintain market integrity. Together with the stock exchange, the clearinghouse and custodian agency have been given special power to govern their members through their own rules and regulations. These institutions are known as SROs. Figure 3.2 shows the Indonesian capital market's structure based on the current legal framework.



Source: Author summary from Law of the Republic of Indonesia No. 8 of 1995: The Capital Market

Figure 3.2 Indonesian Capital Market Structure

[10] Surabaya is the second largest city in Indonesia after the capital city Jakarta.

3.2.4. Two-tier Board System

Indonesian Company Law 2007 and its previous iteration, Company Law 1995, identified three organs of corporations: GMS, the BoC and the BoD. Shareholders' rights are accommodated through the GMS as the highest authority within a company. Moreover, the GMS votes or selects the members for both the BoC and BoD. This mechanism is different from that of the one-tier board system, in which executives/management are voted in by the BoD (supervisory board).

In the two-tier board system, two boards supervise and manage the company; these are the BoC ('Dewan Komisaris') and the BoD ('Dewan Direksi'). The BoC is equivalent to the BoD in the one-tier board system, and performs a supervisory role. The BoD is similar to the executives/management responsible for the daily operation of the company. When comparing the one- and two-tier board systems, the BoC and BoD are quite easily confused. Hence, carefully identification of both terms is necessary when discussing the Indonesian two-tier board system.

In comparison to the one-tier board system in which management (executives) can also serve on the BoD (dual-chair roles), the two-tier board system will only allow individuals to serve on the supervisory board or as management.

3.2.4.1. Board of Commissioners

The Indonesian Company Law 2007 stipulates that the BoC should supervise and advise the BoD in managing the company. BoC members are appointed by the GMS, unless appointed by the founder of the company at its founding. Dismissal from the BoC and compensation packages offered is also determined through the GMS.

The Company Law states the fiduciary duties of the BoC and the consequences for their negligence. There is joint responsibility among board members for any negligence of duties that result in company losses, except where members can prove that they have performed and fulfilled their duties responsibly. It is also stipulated that the BoC should consist of at least one independent commissioner and at least one subcommittee to help the BoC to perform its work. The subcommittee(s) is responsible to the BoC.

3.2.4.2. Board of Directors

The Indonesian Company Law 2007 states that the BoD should manage the company in line with its purpose and objective, as stated in the company article of association. BoD members are elected by the GMS, except where elected by the founder at the company's establishment. Dismissal from the BoD and compensation is also determined through the GMS. For public companies, the BoD should consist of at least two directors.

Company Law states the fiduciary duties of the BoD and the consequences for their negligence. There is a joint responsibility among board members for any negligence of duties that result in company losses, except where members can prove that they have performed and fulfilled their duties responsibly.

3.3. Corporate Governance in Indonesia

3.3.1. Indonesia's Code of Good Corporate Governance

As a response to the issuance of the OECD's Principles of Corporate Governance in 1999, Indonesia as a non-OECD member has opted to follow the principle and establish the National Committee on Good Corporate Governance ('Komite Nasional Kebijakan Good Corporate Governance'). This Committee issued the Indonesian Code of Good Corporate Governance, which mostly adopts the OECD Principles, in 2001. This code was intended to provide guidance based on international best practice for Indonesian business participants with some adjustments to suit the national legal framework.

In 2004, the OECD issued revised Principles of Corporate Governance. This issuance was a result of the OECD steering group review to accommodate new developments and public concerns. Following the revision of the OECD Principles, the Indonesian National Committee on Good Corporate Governance was also transformed, becoming Indonesia NCG on 30 November 2004.

This new committee subsequently issued a revised Indonesian Code of Good Corporate Governance in 2006 to update the earlier 2001 version. This 2006 code follows the revisions of the OECD Principles in 2004. The NCG (2006) states that the Indonesian Code of Good Corporate Governance is a living instrument, and shall continue evolving to reflect economic and business developments. It provides standards and guidance in implementing good corporate governance and it is intended as a reference point for all Indonesian companies (including Islamic operating companies). It offers some basic principles for minimum standards that could be adapted to specific circumstances.

In addition, the code specifies two approaches regarding the implementation of good corporate governance principles: the ethics-based approach and the regulatory-based approach. The ethics-based approach relies on the goodwill and willingness of corporations to implement sound business practices with a view to the long-term relationship with stakeholders. In comparison, the regulatory-based approach forces companies to comply with certain rules and regulations embedded in the corporate governance code. The NCG issues this code with an ethics-based approach intention. Therefore, there is no mandatory obligation for corporations to follow the principles. However, law and regulation in Indonesia accommodate these corporate governance principles, meaning that in practice, a regulatory-based approach is taken (World Bank & IMF 2010). In any case, most Indonesian corporations nowadays are conscious about the importance of good corporate governance practices to maintain long-term value and relationships with stakeholders.

The Indonesian Code of Good Corporate Governance 2006 has been extended in scope to include more of the business industry, and to integrate the general and practical implementation of good corporate governance (NCG 2006). The code is described as a reversed triangle, with the macro aspects and corporate governance principles at the top. It then moves deeper to elaborate on the functions and roles of company organs. Finally, the code specifies the practical implementation of corporate governance for business processes (NCG 2006).

The code begins with the required conducive foundations to implement good corporate governance. Three inter-related pillars, being the regulator, market participants and the public, are required to support the implementations. The regulator serves as the regulatory, supervisory and enforcement executor. Market participants are the business sectors that implement good corporate governance for maintaining long-term relationships with stakeholders. Lastly, the public are the users of any products or services produced by the business sectors. Through good governance implementation, the public comes to value and respect businesses' behaviour, encouraging long-term investment.

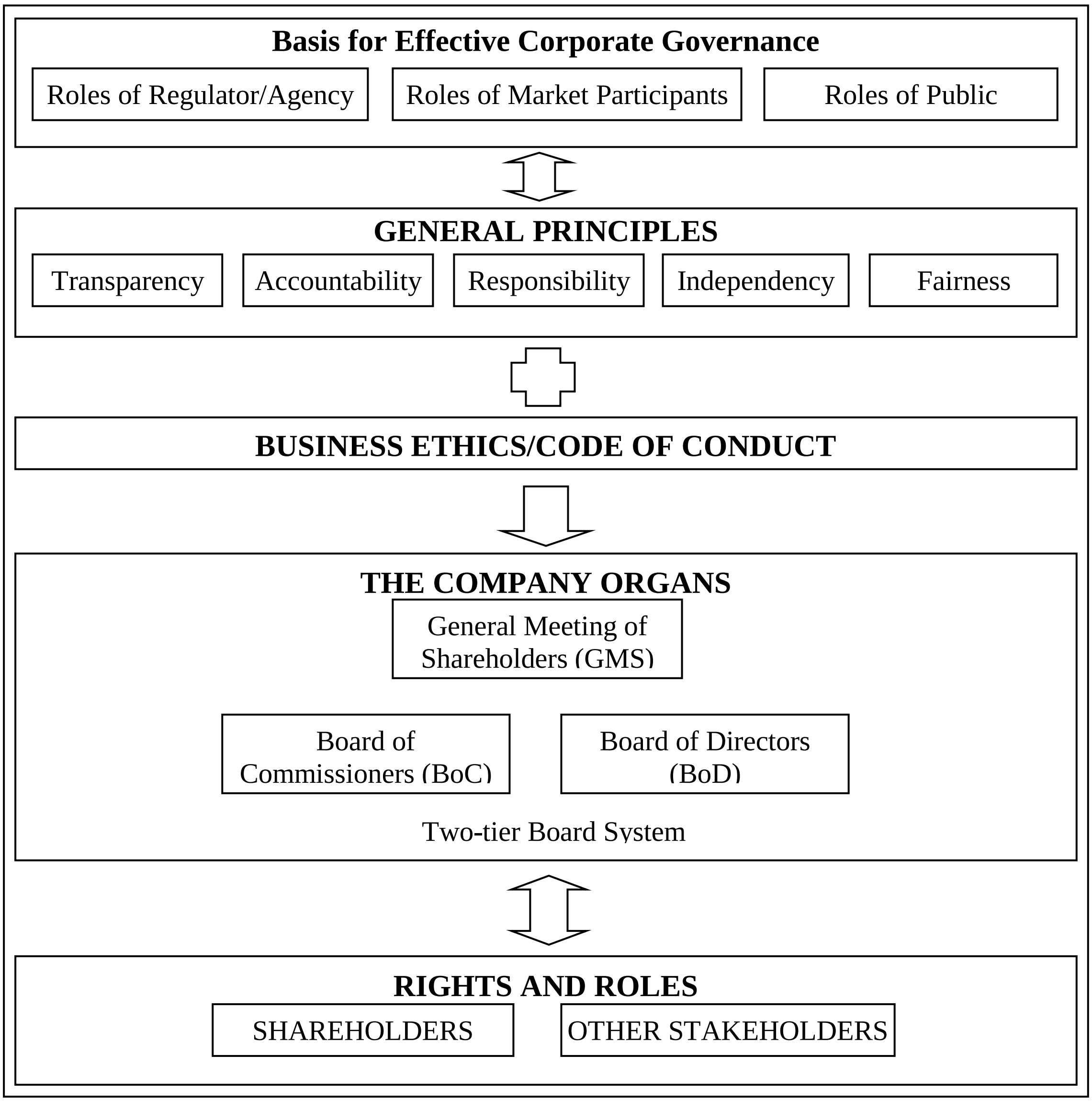
The next part of the code elaborates the main good corporate governance principles, which consist of five elements: Transparency, Accountability, Responsibility, Independency and Fairness. These elements should be implemented in every business step and brought forward into the larger body of the organisation. Transparency refers to openness of doing business, and means that corporations should provide relevant information to stakeholders and the public in a manner easily understood and accessible to all stakeholders. Accountability means that any actions of the corporation should be properly managed and measurable, in line with stakeholders' interests. Responsibility means corporations have to follow rules and regulations when conducting their activities, and fulfil their social and environmental obligation to the community. Independence refers to the freedom of actions by management without any intervention, while still maintaining the balance of power among company organs. Fairness means that corporations should take into account both the interests of shareholders and those of stakeholders, based on fair treatment to both parties.

To support the long-term success of the good corporate governance implementation, companies should rely on company values, business ethics and a code of conduct. Guidance on establishing these three supportive aspects of governance implementation is also provided by the Indonesian Code of Good Corporate Governance 2006.

Further, the code specifies good corporate governance principles for the core company organs of the GMS, BoC and BoD. The code provisions mostly relate to the specific functions of each organ, which they should perform independently based on their roles and responsibilities for the interests of stakeholders. In addition, the code suggests the establishing of committees to support the BoC in its duties. These committees should include at least an AC, and may include other committees such as a Remuneration and Nomination Committee, a Risk Policy Committee and a Corporate Governance Committee.

The next part of the code covers, in detail, the rights and roles of shareholders and stakeholders, and the last part of the Indonesian Code of Good Corporate Governance points out the importance of companies including an implementation statement in their annual report, to confirm their governance implementation level. Where companies choose not to confirm to the Principles of the Code, this should also be disclosed, with reasonable reason given to shareholders and stakeholders.

Figure 3.3 depicts the corporate governance framework in Indonesia, based on the Indonesian Code of Good Corporate Governance 2006.



Source: Author summary from Indonesia Code of Good Corporate Governance 2006

Figure 3.3 Indonesian Corporate Governance Framework

The above code provides good corporate governance principles for general purposes, especially for public companies, but there is also a specific corporate governance implementation for the banking industry. Bank Indonesia as a regulator and supervisor of the banking sector in Indonesia has issued an Implementation of Good Corporate Governance for the Banking Sector (Bank Indonesia 2006). This industry-specific code is part of Bank

Indonesia's regulations, and sets rules that must be followed by the banking industry. For instance, the guidance states that banks have to have a minimum number of BoC meetings per year, and the number of independent BoC members should be at least 50% of total board members.

Likewise, in the area of State-owned Enterprises (SOEs), the 2004 Good Corporate Governance Implementation for SOE's specifically regulates their corporate governance, elaborating governance principles for this company type that complement the general principle of corporate governance.

3.3.2. Corporate Governance Practices in Indonesia

As the OECD has established the Code of Good Corporate Governance as a general guideline, Indonesia has implemented the guideline through law and regulation (adopted a 'regulatory-based approach') and established the Indonesia NCG with its corporate governance code.

The Indonesian Company Law 1995, especially its revision in 2007, adopted the good corporate governance principle. The Company Law has mostly strengthened the roles and responsibilities of the BoC, BoD and (minority) shareholders. The inclusion of good corporate governance principles into company law is intended to improve corporate governance practices in Indonesia.

Bapepam-LK as the capital market regulator in Indonesia has also introduced and amended its regulations to implement good corporate governance principles, especially for issuers/public companies. The five good corporate governance principles of Transparency, Accountability, Responsibility, Independency and Fairness have been accommodated throughout Bapepam-LK's rules, and have been adopted throughout diverse areas and activities of issuers/public companies. There is no specific or single rule to reflect all the principles. However, the principles are implemented according to the specific areas/activities being governed in the related rules. In addition, Bapepam-LK is actively monitoring the implementation of these rules, including the corporate governance aspect, and they enforce any violations, for the protection of investors. Table 3.1 summarises Bapepam-LK's rules and regulations that reflect the implementation of good corporate governance principles.

Table 3.1 Implementation of the Principles of the Indonesian Code of Good Corporate Governance into Regulation

Corporate Governance Principles	Regulated Area/ Activities	Bapepam-LK Rules No.	Description/Title
Transparency	Disclosure of (Initial) Public Offering Process	IX.C.1.	Form and Content of a Registration Statement for a Public Offering
		IX.C.2.	Guidelines Concerning the Form and Content of a Prospectus for a Public Offering
		IX.C.3.	Guidelines Concerning the Form and Content of a Summary Prospectus for a Public Offering
	Continuous Disclosure		
	Periodic	X.K.4.	Reports on the Use of Funds Received from a Public Offering
		X.K.2.	Obligation to Submit Periodic Financial Statements
		X.K.6.	Obligation to Submit Annual Reports
	Incidental	X.K.1.	Disclosure of Information that Must be Made Public Immediately
		X.K.5.	Disclosure of Information by Issuers or Public Companies Regarding Bankruptcy
	Corporate Action	IX.E.1.	Conflicts of Interest on Certain Transactions
		IX.E.2.	Material Transaction and Changing in Core Business
		IX.D.5.	Bonus Shares
		IX.F.1.	Tender Offer
		IX.G.1.	Mergers and Consolidations of Public Companies and Issuers
		IX.H.1.	Open Company Takeover
		IX.L.1.	Procedures For Conducting Quasi Reorganisation
Accountability		IX.J.1.	Articles of Association of Companies Conducting Public Offerings and Public Companies
		X.K.6.	Obligation to Submit Annual Reports
		IX.I.5.	Establishment and Guidance of Audit Committee
		IX.I.7.	Establishment and Guidance of Audit Committee Charter
Responsibility		---	All Rules and Regulation
		IX.I.4.	Establishment of Corporate Secretary
Independency		IX.E.1.	Conflicts of Interest on Certain Transactions
		X.K.6.	Obligation to Submit Annual Reports
Fairness		---	All Rules and Regulation
		IX.E.1.	Conflicts of Interest on Certain Transactions
		IX.H.1.	Open Company Takeover
		X.M.1.	Disclosure of Certain Shareholders

Source: Author summary from Bapepam-LK's rules and regulation

Based on Indonesia's corporate governance implementation, the World Bank and IMF (2004, 2010) have reviewed the above-mentioned implementation in their ROSCs. These reviews use the OECD Corporate Governance Principles as a benchmark, using a template developed by the World Bank. ROSC 2004 recognised that Indonesia had adopted most corporate governance principles into laws and rules, and therefore was rated as 'partially observed'. The report highlights some substantial conditions of corporate culture in Indonesia, especially the focus on OS and business culture. The dominant OS is concentrated ownership in the hands of families or controlling shareholders, even for public companies. The predominant business culture in Indonesia was found to be the relationship-based culture, rather than the rules-based approach. ROSC 2004 also emphasised several weaknesses in corporate governance practices in Indonesia. These are in the categories of company law, enforcement, disclosure issues, company organs and the rights of minority shareholders.

In relation to Indonesian Company Law, the report concludes that the law should explicitly state the fiduciary duties of directors and management for breaking rules and regulations. Further, the review contends that the process of amending Indonesia law needs to be accelerated. It is recommended that Indonesia develop an alternative (non-judicial) method to promote better corporate governance, for instance through shareholder activism.

In the enforcement area, the report criticises enforcement actions taken by the regulator. The report states that sanctions given to perpetrators should be go further than administrative sanctions (fines) alone. Corporate executives, either individually or together, should be liable and accountable for any breach for the purpose of law enforcement. Moreover, the regulator should develop incentives that promote sound business activities. Any breaches in rules and regulations should be responded in order to protect business integrity. To this end, regulator resources and capabilities as an enforcer need to be strengthened to allow for effective enforcement actions.

The corporate governance principles mostly addressed in this report are transparency and reliability. The report stresses that Indonesia's financial statements and annual reports are deficient in their transparency and reliability. This means that public companies should disclose more, and auditors should further emphasise the reliability of information provided to the public. The Indonesian accounting standard largely complies with the international standard. However, implementation by corporations remains distant from the standard.

Another issue that has been observed is the degree of independence of the supposedly independent BoC members. The report questions the appointment process of these independent members due to the non-existence of a nomination committee, asking how the independent member performs his or her role free from controlling shareholder influence. The report argues that the nomination process and capacity building for independent BoC members have to be improved in Indonesia. Other corporate governance factors that need to be enhanced are minority shareholder protection and the mechanisms through which shareholders exercise their rights. The report advises that minority shareholders be given a greater voice (for instance, through cumulative voting) in voting on the BoC membership, and that effective mechanisms be created to protect shareholder rights, and allow for remedy when their rights are violated.

Thus, in summary, the ROSC 2004 report for Indonesia underlines that rules and regulations regarding corporate governance are sufficient and follow the OECD principles. However, significant gaps remain between principles and practice, and there is a need to enforce any violations effectively, to encourage better corporate governance practices (World Bank & IMF 2004).

A more recent review of Indonesia's corporate governance practice was conducted in 2010. The ROSC 2010 states that there have been some significant improvements since 2004, although some obstacles remain that need to be addressed (World Bank & IMF 2010). Specifically, the ROSC 2010 underlines improvements in the areas of board duties, shareholders' rights, and transparency and disclosures. The introduction of the new Indonesian Company Law in 2007, as an amendment of the previous 1995 law, has clearly stated the duties of the BoC and BoD, including their fiduciary duties and the consequences for violating these duties. The new Company Law also provides shareholders with expanded rights to seek proper private remedy. In addition, transparency and disclosure has been improved substantially because of better regulatory requirements imposed by Bapepam-LK. There is a note about disclosure in relation to board compensation disclosure, with most companies disclosing the total amount of compensation for both boards when a breakdown for each board should be reported for complete disclosure. The capacity-building process and responsibilities of the BoC have also been addressed adequately, and the BoC now has truly independent members elected in the proper manner through a nomination committee.

However, the report also highlighted some areas that need further improvement and that are considered as obstacles for good corporate governance practices. The new Company Law 2007 represents a significant improvement, but some aspects are not fully in line with the OECD Principles. The BoC's duties under the new Company Law only follow a few of the OECD Principles. For example, no mention is made about board members' participation in CEO selection,[11] and the fact that minority shareholders do not have power to influence the board member selection process.

The OS of listed companies in Indonesia is also highlighted. The ROSC 2010 mentions that shareholding patterns in Indonesia are still heavily concentrated: on average, the three largest shareholders in a company control 60.9% of its shares (p.8). In relation to ownership patterns, most listed companies in Indonesia could be classified as part of group-controlled or family-owned businesses, state-owned companies or foreign-controlled corporations (World Bank & IMF 2010).

In the area of auditing, the 2010 report emphasises the weaknesses in the regulatory framework. The new Company Law does not specifically regulate the EA selection process, or EA's liabilities to shareholders or the company. Among others, the supervisory function of public accountants is shared between Bapepam-LK and a division of the Ministry of Finance, creating ambiguity of power. Moreover, the report criticises the limited resources of the regulator in supervising the large number of public accounting firms and accountants.

Regarding disclosure, companies rarely reports or disclose their ultimate shareholders and control distribution. This practice affects the regulation of potential conflicts of interest. The report also concludes that shareholders continue to have trouble accessing basic information about companies, such as articles of association on companies' website or other reports. Further, the mandatory statement of corporate government implementation is considered to lack the information to support company governance practice.

[11] This comment is not relevant to Indonesia's legal framework as Indonesian Company Law specifically mentions that the GMS is the highest authority within a firm. The GMS, rather than the BoC, selects the BoD members.

The 2010 ROSC also observes that, in general, shareholders' rights are protected; however, some minor gaps remain. In Indonesia, shareholders are usually not able to propose meeting agendas or ask questions outside the agenda. Further, the revision of the tender offer regulation in 2008 to increase the threshold at which tender offers can be made has resulted in the deterioration to shareholders' rights. Although this new tender offer rule is intended to protect minority interests, large shareholders will suffer, as they will face difficulty to accumulate shares up to the threshold and difficulty in delisting their company from the stock exchange. Further, private remedy actions of shareholders' rights are infrequent, as the court settlement process is costly and lengthy.

Table 3.2 summarises the World Bank and IMF's (2010) findings with regard to the implementation of corporate governance in Indonesia.

Another review of Indonesia's corporate governance comes from the Financial Standards Foundation, a not-for-profit organisation that actively promotes transparency for political and economic affairs around the world through their special eStandards Forum. The review is reported in the Financial Standard Report: Indonesia (eStandardsForum 2009). The report grants Indonesia 'enacted' status, meaning that Indonesia has incorporated most of the OECD standards and principles into its laws and regulations, but has yet to ensure the enforcement of those laws and regulations (eStandardsForum 2009).

The Financial Standards Foundation uses six corporate governance benchmarks, similar to the OECD Principles. These are 1) ensuring the basis for an effective corporate governance framework, 2) the rights of shareholders and key ownership function, 3) the equitable treatment of shareholders, 4) the role of stakeholders in corporate governance, 5) disclosure and transparency, and 6) the responsibilities of the board. From the above six criteria, Indonesia has been given 'enacted' status for five. On one criterion, ensuring the basis for an effective corporate governance framework, Indonesia has been given the status of 'insufficient information'. The Financial Standards Foundation relies on secondary sources (especially the ROSC) when conducting its assessment. Consequently, this assessment produces a similar outcome to the report of the World Bank and IMF.

Table 3.2 Summary of the Corporate Governance Implementation Report for Indonesia by the World Bank and IMF, 2010

	Principle	FI*	BI*	PI*	NI*
I. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK					
IA	Overall corporate governance framework			X	
IB	Legal framework enforceable/transparent			X	
IC	Clear division of regulatory responsibilities		X		
ID	Regulatory authority, integrity, resources			X	
II. THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS					
IIA	Basic shareholders' rights				
IIA1	Secure methods of ownership registration		X		
IIA2	Convey or transfer shares	X			
IIA3	Obtain relevant and material company information		X		
IIA4	Participate and vote in general shareholder meetings	X			
IIA5	Elect and remove board members of the board	X			
IIA6	Share in profits of the corporation		X		
IIB	Rights to part in fundamental decisions				
IIB1	Amendments to statutes, or articles of incorporation		X		
IIB2	Authorization of additional shares		X		
IIB3	Extraordinary transactions, including sales of major corporate assets			X	
IIC	Shareholders GMS rights				
IIC1	Sufficient and timely information at the general meeting		X		
IIC2	Opportunity to ask the board question at the general meeting			X	
IIC3	Effective shareholder participation in key governance decisions			X	
IIC4	Availability to vote both in person or in absentia			X	
IID	Disproportionate control disclosure				X
IIE	Control arrangements allowed to function				
IIE1	Transparent and fair rules governing acquisition of corporate control			X	
IIE2	Anti-take-over-devices		X		
IIF	Exercise of ownership rights facilitated				
IIF1	Disclosure of corporate governance and voting policies by institutional investors			X	
IIF2	Disclosure of management of material conflicts of interest by institutional investors			X	
IIG	Shareholders allowed to consult each other	X			
III. EQUITABLE TREATMENT OF SHAREHOLDERS					
IIIA	All shareholders should be treated equally				
IIIA1	Equality, fairness and disclosure of rights within and between share classes			X	
IIIA2	Minority protection from controlling shareholder abuse; minority interests			X	
IIIA3	Custodian voting by instruction from beneficial owners		X		
IIIA4	Obstacles to cross border voting should be eliminated		X		
IIIA5	Equitable treatment of all shareholders at GMs		X		

	Principle	FI*	BI*	PI*	NI*
IIIB	Prohibit insider trading			X	
IIIC	Board/Managers disclose interest			X	
IV. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE					
IVA	Legal rights of stakeholders respected		X		
IVB	Redress for violation of rights			X	
IVC	Performance-enhancing mechanisms		X		
IVD	Access to information		X		
IVE	‘Whistleblower’ protection			X	
IVF	Creditor rights law and enforcement			X	
V. DISCLOSURE AND TRANSPARENCY					
VA	Disclosure standards				
VA1	Financial and operating results of the company		X		
VA2	Company objectives		X		
VA3	Major share ownership and voting rights			X	
VA4	Remuneration policy for board and key executives			X	
VA5	Related party transactions		X		
VA6	Foreseeable risk factors		X		
VA7	Issues regarding employees and other stakeholders			X	
VA8	Governance structures an policies			X	
VB	Standards of accounting and audits		X		
VC	Independent audit annually			X	
VD	External auditors should be accountable			X	
VE	Fair and timely dissemination		X		
VF	Research conflicts of interest			X	
VI. RESPONSIBILITIES OF THE BOARD					
VIA	Acts with due diligence, care			X	
VIB	Treat all shareholders fairly			X	
VIC	Apply high ethical standards			X	
VID	The board should fulfil certain key functions				
VID1	Board oversight of general corporate strategy and major decisions		X		
VID2	Monitoring effectiveness of company governance practices			X	
VID3	Selecting/compensating and monitoring/replacing key executives			X	
VID4	Aligning executive and board pay			X	
VID5	Transparent board nomination/election process				X
VID6	Oversight of insider conflicts of interests		X		
VID7	Oversight of accounting and financial reporting systems		X		
VID8	Overseeing disclosure and communicative processes			X	
VIE	Exercise objective judgment		X		
VIE1	Independent judgment		X		
VIE2	Clear and transparent rules on board committees			X	
VIE3	Board commitment to responsibilities			X	
VIF	Access to information			X	

** Note: FI=Fully Implemented; BI=Broadly Implemented; PI=Partially Implemented; NI=Not Implemented.*

Source: World Bank and IMF (2010).

In relation to the corporate governance institutional framework in Indonesia, there are organisations specifically concerned with corporate governance. As mentioned previously, Bapepam-LK is the regulator; and the IDX, as an SRO, incorporates corporate governance principles into their rules and regulations. The NCG was established by ministerial decree as a body that represents the public and private sectors to formulate a corporate governance code/guidance. Other institutions include the Indonesian Institute of Corporate Directorship (IICD) and the Forum for Corporate Governance in Indonesia (FCGI), which promote and disseminate good corporate governance practices for Commissioners, Directors and other professionals through continuing training and education. The IICD and FCGI are private professional cooperatives.

3.4. Enforcement in Indonesian Capital Market

Although corporate governance principles have been rigorously implemented through rules and regulations that become mandatory, they are not sufficient to support good corporate governance practice. Monitoring and enforcement are needed to ensure effective implementation. Hence, enforcement action capacity and implementation is required (Brown, Beekes & Verhoeven 2011). La Porta et al. (2002) argue that investor legal protection is an important determinant of the development of capital market. Thus Chen et al. (2005) conclude that the protection of investors' rights through enforcement by regulator has been seen as important as, or more important than the content of the regulation itself.

The Indonesian Capital Market Law 1995 stipulates that capital market activities be supervised by Bapepam-LK. To maintain market integrity, transparency, fairness and efficiency, Bapepam-LK has been given authority to perform any inspections and investigations of any parties involved in capital market activities.

Under the Indonesia Civil law system and capital market legislation, there are two types of investigation: formal and criminal investigations. Formal investigations are conducted in the case of misconduct or violation of capital market rules and regulations, while criminal investigations are exercised when fraudulent activities endanger market integrity, bring loses to other parties or can be categorised as 'crime' by the Indonesian Criminal Code

(‘KUHP’).[12] Formal investigation results in administrative sanctions by Bapepam-LK, whereas criminal investigation leads to criminal proceedings involving other institutions such as the Attorney General’s Office (AGO) and Judges (court prosecution).

To give an example, formal investigations would be conducted by Bapepam-LK for any late submissions of documents and reports, untimely disclosures, or violations of certain capital market procedures; while criminal investigations would be executed for unlicensed parties/activities, insider trading, falsifying documents or reports, misleading information or creating artificial market price or movements. The Capital Market Law specifies the fraudulent activities that lead to either formal or criminal investigations.

The Government Regulation No. 46/1995: The Inspection Procedures in Capital Market further elaborates the procedures and mechanisms used to conduct inspections (The Republic of Indonesia 1995b). As inspections are legal actions and affect other parties’ rights and obligations, the legislation specifies rigid mechanisms that should be followed by Bapepam-LK in conducting inspections to protect all affected parties’ rights and obligations.

3.4.1. Administrative Sanctions

The Indonesian Capital Market Law 1995 articulates administrative sanction types, including letter of notice, fines, limitation of activities, freezing of activities, revocation of license, cancellation of approval and cancellation of registration statement.

The Government Regulation No. 45/1995 details Indonesian capital market activities and types of administrative sanction. However, regarding fines, the regulation only specifically mentions rates (tariffs) related to late submissions of reports or certain disclosure. This is due to the difficulties to quantify and measure fines that are not related to late submission. The penalties would be determined by case complexity and severity for the capital market industry. Bapepam-LK, through its Sanction Committee, determines the appropriate administrative sanctions (including fine amount) and any remedy actions that need to be taken by parties involved.

The fine tariff for late submission is a rate for each overdue day, depending on company classification and report type. For instance, a securities company would have a different fine

[12] The Indonesian Criminal Code, or Kitab Undang-undang Hukum Pidana (‘KUHP’ or ‘*Wetboek van Strafrecht*’), was originally established during Dutch colonisation and remains valid to date as the highest reference for criminal actions in Indonesia.

rate in comparison to a public company. In the case of securities companies, the fine rate for late submission of a report is Rp 100.000,00 per day, with a maximum fine of Rp 100.000.000,00. For public companies, late submission of any report or disclosure obligation incurs a fine at a rate of Rp 1.000.000 for each day overdue, with a maximum fine of Rp 500.000.000. All fines are directly payable to a designated state account.

The sanctioned parties might challenge the initial imposition of any administrative sanctions through a subsequent appeals process. In this case, the sanctions would be referred to the initial imposition unless the regulator accepts the appeal and revises its initial decision.

3.4.2. Criminal Proceedings

In relation to fraudulent activities in the capital market that lead to criminal investigations, Bapepam-LK has to notify the AGO when a case is considered as a criminal action, to make the AGO aware that, at the end of the investigation process, they will have to prosecute the case in court. Bapepam-LK does not have prosecution power. Thus, while Bapepam-LK is fully responsible for the investigation process, once the criminal investigation has reached its final stage, the regulator has to prepare a final investigation report to be submitted to the AGO, which then brings this criminal case to the court for criminal prosecution. As the regulator's responsibility is limited to the final case preparation for the AGO, criminal sanctions are not determined until the final court decision has been made by the judge (court).

As cited by the ROSC 2010 report, court prosecution in Indonesia is costly and lengthy. Therefore, when dealing with perpetrators, Bapepam-LK tends to focus on administrative sanctions with heavy monetary penalties to act as a deterrent (World Bank & IMF 2010).

3.4.3. Other Sanctions by the Stock Exchange

The IDX is a SRO with the authority to set up rules and regulations for listed and securities companies as their trading members. The proposed rules and regulations are submitted for approval to Bapepam-LK. Once these rules and regulations take effect, the IDX has the power to impose sanctions on listed companies and securities companies (broker dealer) for violations. These sanctions can take form of a letter of notice (written warning I, II and III), a fine or a trading suspension.

Any objection by a sanctioned party is to be submitted directly to the regulator. While the case is being reviewed by Bapepam-LK, any sanction acquired is still in effect to the party. The regulator will review the case, and will come to a decision. If the regulator rejects the objection, Bapepam-LK will reinforce the stock exchange's sanction. In contrast, acceptance of the objection will cause a revocation of the sanction or follow-up actions required based on the regulator's decision (Indonesia Stock Exchange 2004).

3.5. Summary

In the Indonesian legal system and institutional framework, two major laws are in place: the Company Law and the Capital Market Law. The history of Dutch colonisation has caused the Indonesian legal system to develop as a Civil law regime, with all rules and regulations being in accordance with this regime. One notable aspect of this regime is its two-tier board system, with the BoC being the supervisory board and the BoD being the executives/management.

This chapter has highlighted the institutional framework and system of responsibilities within the Indonesian capital market. Bapepam-LK is the capital market regulator, while the IDX and its supporting institutions are the operating bodies of the capital market industry. Enforcement action in the Indonesian capital market was also discussed to gain understanding of the processes by which sanctions are imposed by the regulator.

The next chapter will discuss the development of the hypotheses and research design for this study. Drawing on the literature review presented in Chapter 2 and the discussion of the Indonesian legal and institutional framework contained in this chapter, Chapter 4 will elaborate on the relationship between Indonesian corporate governance and the incidence of sanctions, with a focus on the research objectives.

Chapter 4: Development of Hypotheses and Research Design

4.1. Introduction

The previous chapters highlighted the importance of good corporate governance for firm performance and the incidence of sanctions, and reviewed the relevant literature. In this chapter, Section 4.2 highlights the hypotheses that underline the research propositions, and Section 4.3 further develops a research design incorporating these hypotheses and justifies the variables included in the model.

4.2. Development of Hypotheses

The following section presents the hypotheses that will be tested in the study. The discussion is presented under the principal factors and their corresponding variables. The list of factors and their variables (in parenthesis) are OS (Top Shareholders, Number of Block-holders, Ownership by Board), BoC (Board Independency, Board Size, Board Meeting), AC (AC Expertise, AC Meeting) and EA (EA Quality).

Section 4.3 gives a detailed discussion of each variable including their measurements. However, first, this section focuses on the development of hypotheses.

4.2.1. Ownership Structure and the Incidence of Sanctions

The classic work by Berle and Means (1932) concluded that corporations in the US are predominantly held by a large number of small shareholders. Since the ownership is diffused among small shareholders, none has a dominant control or influence over the decisions of the entity. As a result, shareholders enter into a fiduciary relationship with the management, and the management is bound by law to act in the best interests of the owners of the entity. This ownership view has been adopted as a basic analytical framework for modern corporations (La Porta, Lopez-de-Silanes & Shleifer 1999).

Further, as argued by Jensen and Meckling (1976), the modern corporation has created a new concept of OS, where a clear division exists between owners and management. The owners, called the shareholders, have entrusted their investment to the managers, who act as their agents. Denis and McConnell (2003) further confirm that OS is an important element of corporate governance and refer to OS as the identity of a firm's equity and the size of its position.

In the area of corporate governance research, there are two major types of corporate OS: proportional ownership and disproportional ownership. Proportional ownership is further classified as diffused ownership or majority-controlled (or block-holder) ownership (Koh 2008). Disproportional ownership refers to the condition in which shareholders' effective control is not proportionate to the shares held (Adams & Ferreira 2008). This is a variation on the 'one share–one vote' principle.[13] This condition is also referred to as 'minority-controlled ownership'.

With regard to the agency problem, Jensen and Meckling (1976) argue that the type of agency problem will depend on the dispersion of share ownership. The traditional agency problem, usually referred to as the type I agency problem, is believed to originate from a conflict of interest between the principal (shareholders) and the agent (management). The type I agency problem is most likely to occur in companies where the ownership is spread among a large number of shareholders, with each holding a very small percentage of shares. Under a diffused OS, the agency problem manifests as owners being unable to exert sufficient control over management.

The agency problem can also arise among shareholders, especially between majority and minority shareholders. This type of agency problem is referred to as the type II agency problem (La Porta, Lopez-de-Silanes & Shleifer 1999), and often manifests as disproportional OS.

Studies by Shleifer and Vishny (1997) and La Porta, Lopez-de-Silanes and Shleifer (1999) have found that low ownership concentration is an important feature of companies in countries with strong investor protection legislation and an effective enforcement structure. Such corporate environments ensure that the rights of minority shareholders are protected. A significant result of the good protection of shareholder rights is a lack of ownership concentration, where parties are willing to own small percentages of shares if their interests are well protected.

[13] Control rights represents voting rights that shareholders have in a company, while cash flow rights refer to actual investments (out of pocket money) made by shareholders in a company by buying company shares (Claessens, Djankov & Lang 2000).

Majority-controlled firms (high concentration of OS) are more prevalent in countries with weak or a total absence of legal protection for shareholders. The rationale is that, in the absence of strong legal protection, investors will tend to accumulate stakes until they hold a significant controlling power, to protect themselves from the risk of management misappropriation (Shleifer & Vishny 1997).

Initial research on the topic of OS and corporate governance mostly focused on the premise that corporations are widely held by large numbers of shareholders who individually do not have a controlling interest. It is assumed that most shareholders are small and not able to control corporations, which are instead controlled by professional managers (Denis & McConnell 2003).

However, this premise has been challenged and come under scrutiny. Recent studies have begun to acknowledge that this widely held belief about corporations may not be quite aligned with reality. Researchers note the existence, and increasing prominence, of large shareholders within public corporations. This has prompted various authors to conduct research under a framework of concentrated or block-holder ownership (Holderness 2003). It has also been asserted that concentration of ownership could either mitigate or exacerbate the agency problem (Setia-Atmaja 2009).

Holderness (2003) argues that shared and private benefits of control are the two strongest motives for block ownership. Shared benefits of control refer to block-holders' incentives and opportunity to increase their firm's expected cash flow to be shared with all shareholders. That increased of abnormal share price after the formation of large block-shares indicates that other shareholders are motivated by shared benefits of control (Mikkelson & Ruback 1985, as cited in Holderness 2003). Private benefits of control mean that block-holders have incentives and opportunity to spend some of the firm's resources for their own benefit, without considering other shareholders. Evidence of 'premium price', rather than 'exchange price', being paid when trading large block-shares confirms that shareholders who buy block-shares expect private benefits from their large block holdings (Barclay & Holderness 1989, as cited in Holderness 2003). These motives, shared and private benefits, are not mutually exclusive, and can exist together (Holderness 2003).

La Porta, Lopez-de-Silanes and Shleifer (1999) argue that the contribution of OS to enhancing corporate governance implementation depends on some other factors that also shape the corporate governance system. The legal protection of investors, the level of ownership concentration, the development stage of capital markets, market for corporate control and the effectiveness of the BoD are among the other factors that influence the contribution of OS. For instance, in a country with a low level of investor legal protection, the concentration of ownership is more prevalent and there are more frequent cases of expropriation of minority shareholders (La Porta, Lopez-de-Silanes & Shleifer 1999).

A study on the quality of Asian law and its enforcement action to protect investors conducted by La Porta et al. (1998) argued that Indonesia has weak investor protection. Hence, it is expected that OS would be concentrated, resulting in a higher probability of minority shareholder grievances. Claessens, Djankov and Lang (2000) concluded that in nine East Asian countries, including Indonesia, it is common that voting rights (control) exceed the CFRs (ownership) through the pyramid structure, cross-holding and other deviations from the 'one share–one vote' principle (Claessens, Djankov & Lang 2000).

The latest ROSC (World Bank & IMF 2010) reveals that OS in Indonesia remains highly concentrated, with around 60.9% of a listed company's shares owned by its three largest shareholders. The majority of shareholders are foreign investors (67.1%), compared to 32.9% for domestic holders (p.8). As the shareholder record is based on registered ownership, the term 'foreign' investors should be interpreted cautiously. This is because many 'domestic' investors (usually the ultimate beneficial ownership) use 'off-shore' parties or 'special purpose vehicles (SPV)' as their means to own listed companies (World Bank & IMF 2010).

The role of OS to improve corporate governance will vary according to shareholders' identity and size (Denis & McConnell 2003). Hoskisson, Johnson and Moesel (1994) argue that majority holding by institutional shareholders will provide better monitoring and control than individual (atomistic) ownership. In addition, more ownership concentration means more control power to support or oppose management actions (Salancik & Pfeffer 1980).

With regard to the family-controlled situation commonly observed in East Asia public corporations, including in Indonesia, there are arguments to support the positive benefits of family-controlled firms. Family-controlled corporations are more efficient as a result of lower monitoring costs, lesser conflicts between principals and agents, and more advantages in controlling management (Fama & Jensen 1983). Similarly, McConaughy, Matthews and Fialko (2001) argue that family-controlled firms have higher value and are more efficient.

Demsetz and Lehn (1985) also suggest that large shareholders are able to reduce manager expropriation because they have significant economic incentives to minimise agency conflict, as part of their wealth depends on firm performance. In the Indonesian case, most large shareholders are family.

However, these positive benefits of family-control come at a cost to minority shareholders. The benefits of minimising agency conflict between principals and management in family-controlled firms bring another conflict between majority and minority shareholders if the protection of minority shareholders' interests is weak (Maury 2006). Supporting this argument, Siagian (2011) found that family and institutional shareholder control has a negative association with corporate governance implementation level, while government ownership has a positive association.

Based on previous findings and considering the necessary adjustments for the Indonesian conditions, the OS hypothesis is elaborated into three individual hypotheses. As OS can be measured by the three variables of Top Shareholders, Number of Block-holders and Ownership by Board, as discussed below, these hypotheses correspond to these variables.

4.2.1.1. Top Shareholder

Top shareholders have the most power and incentives to control management. Hence, it is expected that top shareholders would control management, encouraging them to work at their peak performance to avoid any incidence of sanctions. Shleifer and Vishny (1986) argue that large shareholders are important to monitor management and their performance, even when the management is working at their best. The role of large shareholders extends to persuading and even replacing incumbent management, in addition to basic monitoring duties. In addition, an increase in ownership by large shareholders will result in them demanding higher profits, increase the chance of takeover and increase the share price (Shleifer & Vishny 1986). Karamanou and Vafeas (2005) also suggest that block-holders (shareholders that own significant stakes in a company) are the best party to monitor management due to having better access to company information.

These arguments help to frame the hypothesis in this study that top shareholders will closely control and monitor management. In the situation that controlling shareholders are common, such as in Indonesia, it is interesting to note that this control is not contestable and is maintained by the controlling shareholder; in this case, the top shareholder (Bebchuk 1999).

This study thus holds that top shareholders are the only dominant party to monitor management, and additional ownership by top shareholders will correspond to demands for better performance, including greater adherence to regulations and avoidance of sanctions. Further, the study takes the approach that family-controlled corporations, typical of the Indonesian situation, will see positive benefits from concentrated ownership. Hence, it is expected that top shareholders will have a negative association with incidence of sanctions. The hypothesis is as follows:

H1: Top Shareholder has a negative relationship with the incidence of sanctions.

4.2.1.2. Number of Block-holders

The number of block-holders reflects the number of individual controlling shareholders, with different incentives to control the corporation. According to Indonesian capital market rules, any member of the BoC or BoD, and any party having at least 5% or more company ordinary shares, should report their ownership to the regulator and disclose themselves in the financial and annual report (Bapepam 1996). In this thesis, number of block-holders refers to number of parties (including top shareholders but excluding BoC and BoD members) with these ownership characteristics (5% or more ownership threshold). These independent block-holders have an incentive to monitor management, as they have larger cash flow stakes in the firm (Jensen 1993; Shleifer & Vishny 1997). Hence, it is assumed that more block-holders would create more ‘motives’ within corporations, leading to conflicts of interest among block-holders. Therefore, it is expected that a greater number of block-holders will negatively affect management performance, through the need to accommodate different ‘interests’ and competition between block-holders. The hypothesis is as follows:

H2: Number of Block-holders has a positive relationship with the incidence of sanctions.

4.2.1.3. Ownership by Board

Lastly, ownership by board indicates the involvement of members from the two boards (in the two-tier board system) in holding control in the corporation. This creates a strong motivation to maintain the company’s good performance and demonstrate their reputation. It is also argued by Denis and McConnell (2003) that ownership by management, in the Indonesian case by BoD members that also serve as company management, will create better alignment between managers’ interests and those of controlling shareholders. This will reduce agency costs between controlling shareholders and management, as they also have shares in the company. Therefore, it would be expected that share ownership by board members would minimise any incidence of sanctions. The hypothesis is thus:

H3: Ownership by Board has a negative relationship with the incidence of sanctions.

4.2.2. Board of Commissioners and the Incidence of Sanctions

Under the Indonesian Limited Liability Company Act 2007, corporations are required to have two boards, a BoD and BoC, known as the 'two-tier board system'. The role of the BoC is to supervise and advise the BoD, whereas the role of the BoD is the day-to-day operation of the company. Compared to the one-tier board system, the BoC has an equivalent role to the BoD, while the BoD has a similar function to management. However, under the two-tier board system, both the BoC and BoD are responsible to the shareholders through the GMS mechanism, which is the highest authority in the corporation (The Republic of Indonesia 2007). The two-tier board system, in which there is a separation between the monitoring and managerial functions, is argued to have a better independent monitoring function of the BoC (Mantysaari 2005).

It is important to note that most corporate governance literature discusses the role of the BoD in the one-tier board system context. To construct the theoretical background and research design for this study, it was necessary to refers to this current literature on the one-tier board system to inform the investigation of the role of the BoC in a two-tier board system. BoC performance is measured by three variables: board independency, board size and board meeting frequency. These variables are discussed below.

4.2.2.1. Board Independency

In relation to board effectiveness in monitoring management, Fama (1980) and Fama and Jensen (1983) argue that the composition of insiders and outsiders on the board is important. Insiders are those board members that are also managers or executives within the company, while outsiders are independent members of the board that are not otherwise employed by the company. Outsiders act as arbiters to the agency problems between insiders and other residual claimants within the company.

Uzun, Szewczyk and Varma (2004), in their study on the association between board characteristics and the occurrence of fraud in the US, concluded that board characteristics were strongly correlated with the occurrence of fraud. Specifically, they found that increasing the number of independent members on the board had a negative impact on the occurrence of fraud within the firm.

Beasley (1996) used a logit regression model to compare firms that had experienced fraud with respect to financial statements and those that had not. He found that the likelihood of financial statement fraud was negatively associated with the proportion of independent members on the board.

Lo, Wong and Firth (2010) found that Chinese firms with more independent directors or less 'parent directors'[14] were less likely to engage in transfer pricing manipulation, which is a type of financial fraud. In relation to non-financial reporting fraud, the findings of Persons (2006) were consistent with the above findings in that a larger proportion of independent directors was associated with a lower likelihood of non-financial reporting fraud. However, Persons found that BoD independence was not a significant variable in reducing the likelihood of financial reporting fraud (Persons 2005).

Abdelsalam and El-Masry (2008) conducted a study to determine the impact of board composition and board OS on the reporting timeliness of companies in Ireland. Variables of board composition included independence and average tenure, while ownership by board included company equity held by board members. Their findings supported the positive role played by independent board members on the timeliness of company reporting.

The Indonesian Company Law of 2007 states that the BoC (which is the same as the BoD in the above literature) should have at least one independent member. The independent commissioner is elected through the GMS and should have no affiliation to any shareholder, other commissioner and director. Here, the term 'independent' as it applies in the two-tier board system is slightly different to how it is used in relation to the one-tier system. In the one-tier board system, independent director refers to directors who are not officers of the company, whereas in a two-tier board system, independence refers to lack of affiliation with

[14] Parent Directors refers to directors who are representatives of the parent company of the listed firm (Lo, Wong & Firth 2010).

shareholders, other commissioners or any others directors. Therefore, it can be argued that the nature of ‘independence’ in the two-tier board system is stronger than in a one-tier system.

Based on the above arguments and considering the role of independent members in the board as arbiters between majority and minority shareholders, the hypothesis relating to board independency and the incidence of sanctions is as follows:

H4: Board Independency has a negative relationship with the incidence of sanctions.

4.2.2.2. Board Size

Lipton and Lorsch (1992) and Jensen (1993), discussing the importance of board size on the effectiveness of corporate governance, argue that smaller board size could improve performance. They assert that boards larger than eight members would impair board performance. Larger boards face coordination and process problems, and the costs associated with additional members do not justify the benefit.

Similarly, Conyon and Peck (1998) argue that board size has an inverse relationship with firm value. A study by Persons (2006) indicates that the likelihood of non-financial reporting fraud is lower when board size is smaller. Yermack (1996) provides evidence that small board size is more effective than large board size in terms of creating firm value. However, Uzun, Szewczyk and Varma (2004) present no significant evidence that board size influences the effectiveness of the board to monitor the occurrence of fraud.

Therefore, based on previous research, it is expected that larger boards will be less effective, thus reducing firm value. This proposition is equivalent to saying that larger board size will tend to increase the likelihood of the firm being sanctioned. The hypothesis is as follows:

H5: Board Size has a positive relationship with the incidence of sanctions.

4.2.2.3. Board Meeting

Lipton and Lorsch (1992) suggest that BoD should have a frequency of meeting at least bimonthly. In addition, a director should spend more than 100 hours annually for each board on which he or she serves. They propose that more frequent board meetings will contribute greatly to the effectiveness of the board’s monitoring function and strengthen the relationships between the independent members. The importance of board meeting frequency is also highlighted by Vafeas (1999). The author contends that board activity, in terms of board meeting frequency, are an important aspect of board operation and effectiveness. However, Uzun, Szewczyk and Varma (2004) did not find any correlation between frequency of board meeting and effectiveness of the board to prevent the occurrence of fraud.

Based on the previous findings, the hypothesis with respect to board meeting and the incidence of sanctions in this study is as follows:

H6: Board Meeting has a negative relationship with the incidence of sanctions.

4.2.3. Audit Committee and the Incidence of Sanctions

As specified by the OECD Principles of Corporate Governance 2004, the AC is responsible for supervising the internal audit service, overseeing the financial reporting process and ensuring the objectivity of the EA, including providing recommendations to the BoD for EA appointment and other non-audit services performed by the EA (OECD 2004).

Having an AC will enhance the BoD’s capacity to monitor management. This is due to the specific knowledge of AC members for understanding financial reporting matters and associated processes. Hence, it could be expected that the AC will provide better monitoring of management and could reduce the likelihood of any violations (Beasley 1996).

In relation to AC independency and the incidence of fraud, Abbott, Parker and Peters (2004) argue that the likelihood of financial reporting restatement and financial reporting fraud decreases with increasing number of independent AC members. They also suggest that more financial expertise among AC members, and more AC meetings a year (at least four times) will contribute to reducing the likelihood of financial reporting restatement (Abbott, Parker & Peters 2004).

A US study by Mustafa and Youssef (2010) on financial expertise among AC members in relation to asset misappropriation found that AC financial expertise was a significant factor in lowering the likelihood of asset misappropriation, only if the expertise was embedded in an independent AC member. Lo, Wong and Firth (2010) supported the argument that financial experts within an AC body will reduce the likelihood of financial fraud in China, specifically as concerns transfer pricing manipulation.

In the Australian public company context, Buckby, Dunstan and Savage (1996) argue that AC independency, the amount of training to committee member and members' financial knowledge and experience increase ACE. Song and Windram (2004) examined the effectiveness of UK firms' ACs in monitoring the financial reporting process, concluding that active AC, in terms of meeting frequency in a year, enhanced ACE. Thus, it is expected that an effective AC would provide better a financial reporting process and minimise the likelihood of fraud. Ika and Ghazali (2012) contend that ACE is one major consideration affecting the timeliness of financial reporting in Indonesia. Since delay in financial reporting is considered a violation of regulation, ACE would minimise the incidence of sanctions.

In Indonesia, Bapepam-LK as regulator has stipulated that AC should consist of a minimum of three members, with at least one independent member from independent BoC serving as the committee chair, and at least two members from outside the company without any affiliation with the company's shares, shareholders, commissioners, directors, EA or other company professionals. In addition, at least one member of the AC should possess accounting and/or financial expertise (Bapepam-LK 2004). To meet these requirements, ACs in Indonesian public companies must comprise all independent members. As suggested by Bédard and Gendron (2010), three requirements must be met for an AC member to be classified as independent; that is, they should be free from any employment, personal or business relationship with the company.

Considering that all AC members are already independent as required by regulation, this study will not include AC independency as an explanatory variable. Therefore, only two AC attributes need to be considered in the measurement: expertise and frequency of meeting. The hypotheses for AC expertise and frequency of meeting are as follow:

H7: Audit Committee Expertise has a negative relationship with the incidence of sanctions.

H8: Audit Committee Meeting has a negative relationship with the incidence of sanctions.

4.2.4. External Auditor and the Incidence of Sanctions

As corporate governance participants include a broad array of parties, the role and integrity of EAs have been questioned in light of recent corporate scandals. Law (2011) reviewed the recent corporate governance literature and identifies that type of EA has become an important explanatory variable in relation to the likelihood of fraud. Type of EA refers to the quality of the EA, with the literature frequently using the auditor quality proxies of Big 4 or non-Big 4 accounting firms. Lee, Cox and Roden (2007) researched the Big 4 auditors, determining that they perform their auditing tasks with better quality, in turn increasing the quality of firms' financial reporting. In the US, Perols (2008) observed the characteristics of organisational fraud and concluded that use or non-use of a Big 4 auditor is an important criteria in determining organisational fraud.

Thus, based on previous research, EA quality is an important factor in determining financial reporting quality and the likelihood of fraud. The following hypothesis is proposed:

H9: External Auditor Quality has a negative relationship with the incidence of sanctions.

Table 4.1 below summarises all the research hypotheses formulated for this study.

Table 4.1 Summary of Research Hypotheses

Corporate Governance Attributes	**Hypothesis**	
Ownership Structure		
Top Shareholders	H1	Top Shareholders has a negative relationship with the incidence of sanctions
Number of Block-holders	H2	Number of Block-holders has a positive relationship with the incidence of sanctions
Ownership by Board	H3	Ownership by Board has a negative relationship with the incidence of sanctions
Board of Commissioners		
Board Independency	H4	Board Independency has a negative relationship with the incidence of sanctions
Board Size	H5	Board Size has a positive relationship with the incidence of sanctions
Board Meeting	H6	Board Meeting has a negative relationship with the incidence of sanctions
Audit Committee		
Audit Committee Expertise	H7	Audited Committee Expertise has a negative relationship with the incidence of sanctions
Audit Committee Meeting	H8	Audited Committee Meeting has a negative relationship with the incidence of sanctions
External Auditor		
External Auditor Quality	H9	External Auditor Quality has a negative relationship with the incidence of sanctions

4.3. Research Design

This second part of this chapter discusses the research design for the study. Section 4.3.1 presents a conceptual diagram of the hypotheses. Sections 4.3.2–4.3.4 explain the selection of the dependent, independent and control variables, respectively, and give their definitions and measurements. Next, Sections 4.3.5 and 4.3.6 outline the data and sample collection and methodology used to test the hypotheses, including the model development. Section 4.3.7 gives a brief summary of this chapter.

4.3.1. Conceptual Framework

Based on the development of the hypotheses in the previous sections, Figure 4.1 shows the conceptual framework mapping the relationship between corporate governance attributes, related hypotheses and the incidence of sanctions.

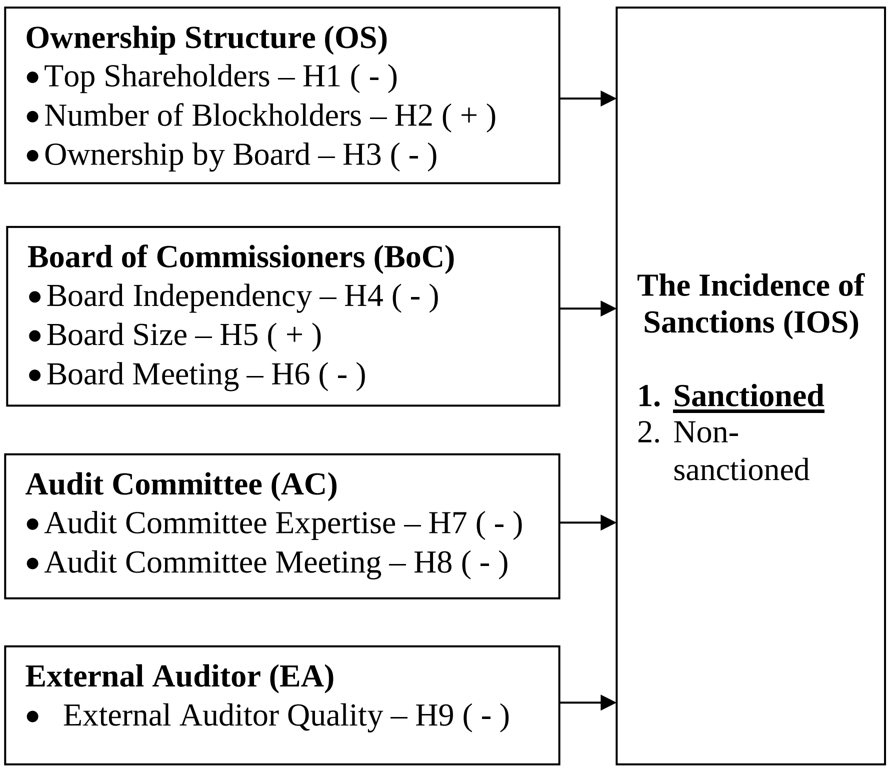


Figure 4.1 Conceptual Framework

4.3.2. The Dependent Variable: Incidence of Sanctions

This study attempts to research the relationship between various corporate governance attributes and the incidence of sanctions in the Indonesian capital market. The first part of this chapter (Section 4.2) reviewed the previous research findings regarding corporate governance attributes as explanatory variables and formulated hypotheses in relation to the dependent variable, incidence of sanctions.

As advocated by La Porta et al. (2002) and Chen et al. (2005), investor legal protection through enforcement action is a key component of capital market development, and has been recognised as being as important as, or even more important than, regulation content. Any violation of the rules and regulations will result in an investigation process by Bapepam-LK as the Indonesian regulator or by the stock exchange as a SRO.[15] At the end of the investigation process, a legal opinion is formed about the conduct, followed by a decision on the appropriate penalty for the breach. This is referred to as a sanction.

Sanction is the final step of the enforcement process by the regulator, and has the intention to have a deterrent effect, recover any losses, protect the interests of stakeholders and maintain market integrity. Thus, the incidence of sanctions is a dependent variable, influenced by a complex interaction of corporate governance attributes as explanatory variables.

In relation to the dependent variable, this study takes a slightly different approach than previous research, which has principally focused on the occurrence of violations or fraudulent activities only in a specific area, either financial (see Beasley 1996; Lo, Wong & Firth 2010; Persons 2005) or non-financial (see Persons 2006). By contrast, this study looks at violations or misconduct by listed companies in Indonesia more generally, by examining all sanctions determination by the regulator. Hence, the incidence of sanctions as the dependent variable will vary, ranging from simple violations such as late submissions of reports to complex situations such as conflicts of interest.

In addition, this study approaches suspicious violations or misconduct based on sanction determination data, which comes at the end of the investigation process by the regulator. This is because data regarding listed public companies involved in violations or fraudulent activities are not readily available through the regulator’s website. For comparison, the US

[15] See Chapter 3 for an explanation of SROs.

SEC website make available Accounting and Auditing Enforcement Releases (AAER), which are continuously updated as cases develop, from the beginning of the investigation until the sanction is given. However, in the Indonesian case, violations or fraudulent activities and the progress of their investigation are not updated regularly and displayed online through the regulator website. Moreover, it is possible to have situations in which suspicious violations or fraudulent activities are not confirmed or supported by enough evidence in the later stage of investigation. Therefore, it is better to obtain confirmation regarding any violations by listed companies through the sanction determination data, generated at the end of the investigation process.

In the Indonesian capital market, Bapepam-LK as regulator has power to investigate any violations or fraud by any persons/parties/corporations that obtain business/professional licenses, approvals or registration. Types of violations will vary from administrative procedures, such as late submission of reports, to more serious violations, such as misleading information, manipulation of financial statements or fraudulent activities in the capital market (The Republic of Indonesia 1995c). The Indonesian Capital Market Law specifies two types of investigation conducted by Bapepam-LK: formal (administrative) and criminal investigation. Formal/administrative investigations are conducted for misconduct or violations of capital market rules and regulations, whereas criminal investigations are exercised for fraudulent activities that endanger market integrity, bring loses to other parties or are categorised as 'crime' by the KUHP.

Administrative sanctions as a result of administrative investigations include letter of notice, fines, limitation of activities, freezing of activities, revocation of license, cancellation of approval and cancellation of registration statement. A supplementary government regulation has specified fines rates (tariff) for late submission of reports/disclosures (The Republic of Indonesia 1995b). If administrative sanctions are related to late reporting/submissions, companies will be sanctioned according to these specific rates/tariffs. However, frequently, administrative investigations involve situations that are more complex, and sanctions must be determined based on case complexity and severity.

With regard to criminal investigations in the capital market, Bapepam-LK is responsible for case investigation and final case preparation for the AGO. After the final case investigation is handed over to the AGO, Bapepam-LK is no longer responsible for the criminal case. Case prosecution is performed by the AGO and criminal sanctions are determined through court judgment.

Despite enforcement action by the regulator, the IDX as an SRO has power to impose sanctions for violations of listing and trading rules by listed companies (Indonesia Stock Exchange 2004). Type of sanction available to the stock exchange is limited to administrative sanctions for rule infringement. However, the stock exchange also has the obligation to detect any breaches of Capital Market Law and regulation other than exchange rules, and including criminal actions, with these cases then brought to the regulator for further investigation.

IDX sanctions are limited to written warning (letter of notice), fines and suspension of trading, listed according to their severity. With regard to submission of financial statement obligations, the sanctions imposed, in order of severity, according to the number of days late, are written warning I, II and III, fines and suspension. Other than for late financial statement submission, the imposition of sanctions is determined on a case-by-case and level of severity basis.

Based on the above description, the dependent variable, incidence of sanction, would ideally be sourced from Bapepam-LK and stock exchange data. However, due to stock exchange data limitations for the sample period, sanction data has been sourced from Bapepam-LK only.

Another important note is that the imposition of sanctions usually follows some time after the occurrence of breaches or misconduct. This is because, before the sanction judgment can be made, the investigation process and administrative procedures must be conducted. This implies that it is rational to measure corporate governance attributes (the independent variables) in the year when the misconduct or breaches happen, and then follow the sanction imposition accordingly to the next period.

This study observes the corporate governance attributes (independent variables) of listed companies for the period of 2007–2010. The incidence of sanctions (dependent variable) is given by a binary value, with value '0' indicating a not sanctioned company and value '1' indicating a sanctioned company.

For breaches of regulations, entities receive one of five levels of sanctions depending on the severity of the breach. They are:

Level 1	Letter of Notice
Level 2	Fine
Level 3	Limitation of Activities, Freezing of Activities
Level 4	Revocation of License, Cancellation of Approval, Cancellation of Registration Statement
Level 5	Criminal proceedings.

Sanctions levels 1–4 are administrative sanctions, whereas level 5 is a criminal proceeding. These sanctions are based on articles 102–110 of the Indonesian Capital Market Law and they reflect the varying severity of breaches. Level 5, criminal proceedings, is not actually a sanction; it is an investigative process that regulators perform before handing the case over to the AGO, with the criminal sanction being determined by court judgment.

In this study, the Level 5 sanction will not be considered. This is because reaching a criminal sanction judgment through court settlement takes a long time, and is subject to appeals. Also, if in a particular period a company has been sanctioned at more than one level of sanctions for multiple breaches, the highest level applies.

4.3.3. The Independent Variables

As discussed above, the decision on sanctions lags behind the factors that may have contributed to the decision due to the time taken to complete the investigation and administrative procedures. As a result, the measurement of corporate governance variables for the period before the sanction imposition is deemed appropriate. Moreover, the corporate governance in place should prevent the fraud/breaches that lead to the incidence of sanctions (see Chen et al. 2006).

4.3.3.1. Ownership Structure Variables

Denis and McConnell (2003) define OS as the identity of a firm’s equity holders and size of their holdings. Achmad (2007) suggests the main measurement of ownership is distribution of shares held by owners (shareholders). This is measured as ratio of shares held by certain shareholders to total number of outstanding shares. In addition, ownership and control are rarely completely separated within a firm. An owner, because of their shares held, to some extent will have power/control over a company, while the controller/management could also have shares of the firm (Denis & McConnell 2003).

La Porta, Lopez-de-Silanes and Shleifer (1999) researched corporate ownership around the world and found OS outside the US to be quite different from OS in the US as proposed by Berle and Means (1932). Berle and Means (1932) argued, with reference to large corporations in the US, that most modern corporations are widely held. However, La Porta, Lopez-de-Silanes and Shleifer (1999) found that most large corporations outside the US have controlling shareholders, either state or family, especially in countries with poor investor protection. These concentrated ownership situations represent a deviation from the 'one share–one vote' principle. In these situations, the voting rights that give control or 'voice' are usually in excess of their CFRs because of the pyramidal structure effect. The controlling shareholders place their representatives or even put themselves in the top management, to protect their interests. Hence, they have an incentive to expropriate minority shareholders. This separation of ownership and control is not in line with the idea of Berle and Means that owners give up their control of the company to professionals/managers. Therefore, in addition to the conflicts of interest between owners and management (the agency problem in situations of a separation of ownership and control), in countries with concentrated ownership, the agency problem is between controlling shareholders and minority shareholders (La Porta, Lopez-de-Silanes & Shleifer 1999).

In Indonesian-listed companies, OS is usually highly concentrated. The World Bank and IMF (2010) observe that, on average, the three largest shareholders in any listed company control around 60.9% of shares (p.8). In addition, in Indonesia, actual ownership ('beneficial ownership') data is hard to obtain, as annual report data only display direct ownership ('registered ownership').

In conjunction with the previous discussion and hypothesis development regarding OS, especially hypotheses H1, H2 and H3, this study proposes three independent variables related to OS attributes, which are Top Shareholders (OSTop), Number of Block-holders (OSBlock), and Ownership by Board (OSBoard5Percent).

The Top Shareholder (OSTop) and Number of Block-holders (OSBlock) variables are intended to measure the magnitude of share concentration and competing controlling shareholders within a corporation. The OSTop variable is specifically to measure the strength of control by the largest shareholders. Higher share ownership means more control by the shareholder and a reduced likelihood of conflicts of interest between shareholders and management. The OSBlock variable further measures block-holders' interactions and competing activities for controlling interests, which in turn either support or detract from management performance.

In this study, the Ownership by Board (OSBoard5Percent) variable is to show board members' share ownership, where members of either the BoC or the BoD own 5% or more of company shares. As advocated by Fama (1980) and Jensen (1993), share ownership by BoD members reduces conflicts of interest between shareholders and directors, and helps to align the interests of directors and management. This study looks at ownership by both the supervisory board and the management board, to determine their controlling power towards the performance of the company and maintenance of the good reputation of the firm. Jensen and Meckling (1976) also support the notion that ownership by management (referred to as 'owner-managers') will alleviate the agency problems that arise from the separation of ownership and control.

All data for these ownership variables are obtained through equity data in annual reports or financial statements for the period of observation. The OSTop variable is the largest share percentage owned by a controlling shareholder. The OSBlock variable is the number of parties, including top shareholders, that hold 5% or more of company shares. The threshold of 5% is taken from Bapepam-LK's rules of disclosure for shareholders, which require any commissioner or director holding any amount of company shares, or any parties holding 5% or more of company shares, to report to Bapepam-LK no later than 10 days after the date of acquisition or transaction (Bapepam 1996). This reporting requirement also applies to any change in that condition, such as changes of ownership because of share selling. In addition, listed public companies should disclose any parties with 5% or more ownership in the equity section of their annual report or financial statement. The OSBoard5Percent variable refers to the number of BoC or BoD members that hold 5% or more of company shares.

4.3.3.2. Board of Commissioners Variables

A two-tier board system comprises a BoC and a BoD. In comparison to the one-tier board system, the role of the BoC is equivalent to that of the BoD, while the BoD has a similar role to top management. Thus, in discussing the two-tier board structure of Indonesia, it is important to distinguish between these boards and the functions.

Fama and Jensen (1983) argue that the BoD should function as the representative of shareholders, including by minimising the costs associated with the separation of ownership and control. Therefore, a BoD with a good composition is an important contributing factor to its effectiveness (Fama 1980; Fama & Jensen 1983).

To respond to hypotheses H4, H5 and H6 on BoCs, this study proposes the three independent variables of Board Independency (BocIndSize), Board Size (BocSizeClass) and Board Meeting (BocMeetFreq).

Board Independency (BocIndSize) Variable

Beasley (1996) studied the relationship between BoD composition and the occurrence of financial statement fraud, especially as regards the proportion of insiders and outsiders on the board. The inclusion of outsiders (non-management) on the board was found to increase board effectiveness, as outsiders have incentives to maintain board integrity, and they often provide more expertise (Beasley 1996). This supports the importance of independent board members for enhanced board effectiveness.

The proportion of independent (outside) directors on a board was also found to be important for preventing manipulation of transfer pricing for related party transactions in Chinese-listed companies (Lo, Wong & Firth 2010). These authors concluded that companies with a higher proportion of independent directors had a smaller probability of the occurrence of manipulation. In addition, they found that having different people occupying the roles of board chair and CEO reduced the occurrence of manipulation (Lo, Wong & Firth 2010).

However, Berglof and Claessens (2006) contend that board independence will not significantly contribute to corporate governance effectiveness in a majority-controlled firm situation. This is due to the significant control possessed by owners and their influence to appoint representatives to the board to safeguard their interests. Nonetheless, independent directors still have a role to disseminate knowledge at the firm level and promote good governance at the country level (Berglöf & Claessens 2006).

Board Size (BocSizeClass) Variable

One of the features of a BoD is its size. Previous studies have been conducted on the importance of board size for board effectiveness and company performance (for example, Lipton & Lorsch 1992; Jensen 1993; Uzun, Szewczyk & Varma 2004; Yermack 1996; Mak & Kusnadi 2005; Beasley 1996; Karamanou & Vafeas 2005; Persons 2006; Haniffa & Hudaib 2006). However, there are three different opinions regarding board size: preference for smaller board size, advocacy of a larger board, and indifference towards board size.

Lipton and Lorsch (1992), Jensen (1993), Yermack (1996) and Persons (2006) argue that smaller board size is important, as this can improve performance while eliminating unnecessary coordination problems. Beasley (1996) and Karamanou and Vafeas (2005) propose that larger boards are more effective, as they provide more expertise and resources for the BoD. However, Uzun, Szewczyk and Varma (2004) find no evidence that board size affects board effectiveness.

Board Meeting (BocMeetFreq) Variable

BoD meeting frequency is an important factor affecting board performance and thus improving corporate governance quality. Lipton and Lorsch (1992), Vafeas (1999) and Conger, Finegold and Lawler (1998) support the importance of board meeting frequency for corporate governance effectiveness. The BoD should meet at a minimum of bimonthly, with six to eight times a year being preferable. In addition, board meetings should be held for the whole day, and a director should spend more than 100 hours annually to serve the board (Lipton & Lorsch 1992).

However, Jensen (1993) and Uzun, Szewczyk and Varma (2004) oppose this view. Jensen (1993) argues that board meeting time limitations would restrict outside directors from exchanging important ideas with board members and positively contributing to board effectiveness. Moreover, the regular tasks of board members consume a great deal of time and the meeting agenda is always set by executives (Jensen 1993). With regard to fraud prevention, Uzun, Szewczyk and Varma (2004) did not find any significant evidence about board meeting frequency and the occurrence of fraud.

All data about BoC variables are sourced from companies’ annual reports. The BocIndSize variable is the size (that is, proportion) of independent board members to total board size, while the BocSizeClass variable is the total size of the board (that is, total number of members). The BocMeetFreq variable refers to how often the board meets in a year.

4.3.3.3. Audit Committee Variables

In Indonesia, in 2004, the formation of ACs became mandatory for all public companies based on Bapepam-LK Rules Number IX.I.5. This rule requires that ACs consist of at least three members, including at least one independent member from independent BoC who should also be the committee chair, and a minimum of two other independent members outside corporation. Further, at least one of the AC members should have knowledge in the area of finance or accounting, and all members should be experienced with financial statements.

Beasley (1996) supports the importance of the AC for enhancing the board’s capacity to monitor management. With their knowledge and expertise, the AC provides valuable assistance to the board, and reduces the likelihood of code or regulation violations. From the regulatory perspective, an AC is needed to strengthen the quality of financial information and support investor confidence about company financial reporting (Bédard & Gendron 2010).

One of the measurements for financial reporting quality is the occurrence of restatements, an explicit acknowledgement of material omissions or misstatements in prior reporting. In relation to this characteristic, Abbott, Parker and Peters (2004) research whether AC characteristics have an association with restatement occurrence. They conclude that AC independence, committee activity and member expertise have a significant and negative association with the occurrence of financial restatements (Abbott, Parker & Peters 2004).

DeZoort et al. (2002) propose composition, authority, resources and diligence as the factors that contribute to the effectiveness of an AC. Composition refers to the structure of the AC, while authority derives from the power given by law and regulation. Resources are the knowledge and expertise of the committee, and diligence is associated with the process of achieving committee effectiveness, such as through committee meetings. Krishnan (2005) also suggests that AC quality can be measured through the dimensions of committee size, independency and expertise.

Bédard and Gendron (2010) review considerable literature in relation to AC and its effectiveness to strengthen financial reporting based on five AC characteristics: the presence of AC, members' independence, members' competencies, number of AC meetings and committee size. They conclude that only AC presence, members' independence and members' competencies are supported by most literature as having an effect on corporate governance effectiveness (Bédard & Gendron 2010).

Based on previous literature, this study will employ only the AC attributes of AC expertise and AC activity (referring to meeting frequency). The AC independency attribute will not be measured. This is because AC presence and independence is mandatory for all Indonesian public companies. The two variables focused on in this study, AC expertise and AC meeting, correspond to hypotheses H7 and H8 in the previous section.

Audit Committee Expertise (ACExpSize) Variable

Lee and Stone (1997) argue that AC members should have relevant experience and qualification (competencies) to perform their duties effectively. AC competencies consist of financial literacy and expertise, where financial literacy refers to the ability to read and understand financial reports, and financial expertise relates to background experience and qualifications. Bédard and Gendron (2010) and Song and Windram (2004) argue that AC competencies have a positive association with ACE.

ACE will have a significant positive impact in reducing agency problems and preserving stakeholders' interests. Therefore, it will maximise overall company value (Mohiuddin & Karbhari 2010). In addition, with regard to the timeliness of financial reporting, an effective AC would enhance timeliness of financial statement release to the public (Ika & Ghazali 2012). Krishnan and Lee (2009) find a strong negative relationship between AC financial expertise and litigation risk, while Mustafa and Youssef (2010) find that AC members with financial expertise could reduce the likelihood of misappropriation of assets.

Audit Committee Meeting (ACMeetFreq) Variable

Raghunandan and Rama (2007) argue that the only way to measure AC diligence quantitatively is through frequency of meetings. This is due to the public availability of meetings data owing to the emphasis placed by the regulator on its disclosure. Further, previous research has highlighted that frequency of AC meeting relates to positive financial outcomes for companies (Raghunandan & Rama 2007).

Xie, Davidson and DaDalt (2003) and Song and Windram (2004) support the argument about the importance of AC meetings for committee effectiveness. In relation to earnings management, frequent AC meetings reduce the likelihood of earnings management by executives. Meeting four times a year is considered an ideal condition to maintain ACE (Abbott et al. 2007).

Turley and Zaman (2007) criticise the approach of using frequency of meetings as a measurement for AC diligence. This approach is considered as a crude proxy to measure AC activity. Moreover, Bédard and Gendron (2010) argue that AC meeting frequency has a minimal impact on committee effectiveness. However, considering the unavailability of other AC activities data rather than meeting frequency, this study employs AC meeting frequency as one of independent variable.

All data for AC attributes are acquired from companies' annual reports. The ACExpSize variable is the size (that is, proportion) of AC members that have an accounting or finance background compared to total member number. The ACMeetFreq variable refers to the frequency of AC meetings in a year.

4.3.3.4. External Auditor Variable

Directors and EAs are the frontline to protect investors and public interests from misbehaviour by management, especially in the area of financial reporting (Baker & Anderson 2010). Bourke (2006) supports the argument that EAs influence corporate governance effectiveness, and thus have a relationship with the incidence of financial statement fraud.

Fan and Wong (2005) observe the role of EAs in emerging markets, where the central agency problems are between controlling and minority shareholders. They argue that the typical corporate governance mechanism is not adequate to minimise this problem. Hence, the EA is expected to play a mitigation role. The authors confirm that the Big 5 auditors have a positive influence on corporate governance in emerging markets (Fan & Wong 2005).

To perform this duty satisfactorily, EAs need to be independent and professional. They have to serve an intermediary role between management and shareholders, based on international accounting standards and acting impartially. Factors affecting the performance of EAs to assure companies’ financial information are length of auditor assignment period and type of accounting firm (that is, whether it is one of the Big 4) (Bourke 2006).

The length of auditor assignment period refers to for how many financial periods an EA has been assigned to the company. This matter implies two contradictive effects. On the one hand, the longer the firm’s assignment tenure (multiple financial years), the better its understanding of the company will be, leading to better quality assurance of audited financial statements. However, longer tenure could see a relationship develop between the firm and the company, possibly endangering the independency of the EA. For this reason, the regulator has prohibited accounting firms from auditing issuers or public companies for six consecutive financial years without a year break. Moreover, the auditor who signs the reports is not allowed to audit for three financial years in a row without a year break (Bapepam-LK 2011). This limitation is in place with the intention to protect the independency of the EA.

Type of accounting firm refers to whether the firm is one of the Big 4 firms. This categorisation arises because investors believe that the auditing services performed by different accounting firms will result in different audit quality (Simunic 1980). Investors perceive the Big 4 auditors as more credible and providing higher audit quality (Gray & Ratzinger 2010). To date, the Big 4 accounting firms are Deloitte and Touche, Ernst and Young, PricewaterhouseCoopers and KPMG. A decade ago, Arthur Andersen was also a ‘Big’ firm (one of the Big 5), but they collapsed in 2002. These Big 4 accounting firms have branches and affiliates around the globe. Hence, they operate in almost every nation.

Research has shown that the Big 4 accounting firms have a positive effect on financial statement quality. For example, Lee, Cox and Roden (2007), Pucheta-Martínez and De Fuentes (2007) and Francis and Yu (2009) argue that the Big 4 accounting firms provide better quality auditing services, while Perols (2008) confirms that auditing by a firm that is one of the Big 4 is a significant variable to detect organisational fraud. Based on these findings, it is expected that the EA variable, in terms of quality measured by whether the firm is one of the Big 4 accounting firms, will relate to the effectiveness of corporate governance. Thus EA quality, to some extent, should have an inverse relationship with the incidence of sanctions.

This study employs a dummy variable for External Auditor Quality (EAQual). Big 4 auditors are assigned a value of 1, and non-Big 4 auditors are assigned a value of 0. This EA quality variable corresponds to the hypothesis H9 in the previous section. The EAQual variable is obtained from companies' audited financial statements.

4.3.4. Control Variables

In addition to the independent variables discussed above, this study includes some non-corporate governance-related control variables that might influence corporate governance implementation and subsequently its effectiveness to reduce the incidence of sanctions. The additional characteristics of companies as measured by control variables may provide explanation for differences of corporate governance effectiveness. By controlling additional characteristics of firms and its impact, this study is expected to focus on the relationship between corporate governance and the incidence of sanctions.

4.3.4.1. Company Size (AssetClass) Variable

The size of the company may influence the effectiveness of its corporate governance implementation. Based on US SEC regulation changes, Ettredge et al. (2011) argue that disclosure requirements for small and large firm registrants are differentiated due to the lack of sufficient qualified personnel inside small firms. Conversely, Khanchel (2007) proposes that smaller firms might have to show better corporate governance mechanisms due to their growth opportunity and greater need for external financing. Da Silva Rosa, Filippetto and Tarca (2008) hypothesise that Australian small companies are more likely to receive ASIC actions as a result of their restricted resources. However, these authors could not find significant evidence on this matter, as they found that ASIC deliberately targets large firms (Da Silva Rosa, Filippetto & Tarca 2008).

The above arguments confirm that firm size may affect company disclosure capabilities and governance mechanisms. Hence, it is expected that firm size will influence the incidence of sanctions. Firm size is measured using the AssetClass variable, which categorises companies based on their total assets at the end of every year.

4.3.4.2. Listing Age (AgeClass) Variable

Listing Age measures how long a company has been listed on the stock exchange. Hence, it controls for differences in the length of time that common stock has been observed and traded by the public (Beasley 1996). The age of a company could affect the likelihood of fraud occurrence. Newly listed companies have greater incentives to 'manage' their financial reporting (Beneish 1999). This is due to the greater pressure for these companies to meet earnings targets (Carcello & Nagy 2004). Moreover, newly listed companies have greater motive to alter their financial figures to secure initial investment capital (Archambeault 2000).

Further supporting these arguments, it is rational to argue that the longer companies have been listed and fulfilled all regulator and stock exchange requirements, the better companies are likely to be at implementing good corporate governance, reducing their likelihood of being sanctioned. Thus, the AgeClass variable would be expected to have some effect on the incidence of sanctions.

As Indonesia initially had two stock exchanges (the JSX and the SSX), which merged to become the IDX, the starting listing period was determined as the earliest listing year on any exchange. The AgeClass variable thus refers to years since the company was first listed.

4.3.4.3. Industry Variable

Corporate governance structures may differ across industry sectors (Dechow, Sloan & Sweeney 1996). Da Silva Rosa, Filippetto and Tarca (2008) argue that different industry sectors produce different corporate governance scores in conjunction with ASIC actions. However, they further confirmed that industry membership is not a significant factor affecting corporate governance scores (Da Silva Rosa, Filippetto & Tarca 2008).

Based on previous finding, this study does not categorise companies across specific industry sectors. Rather, this study employs the general industry classifications of financial or non-financial industry sector. This is because, in the Indonesian financial sector, and specifically in the banking industry, specific corporate governance regulation for banks are issued by the Indonesian central bank (Bank Indonesia 2006). These regulations are an extra level of governance concerned with regulating the prudential risk faced by the banking industry. It is thus expected that the financial sector, with this extra regulation, would show better governance implementation than the non-financial sector, reducing the likelihood of companies in this sector being sanctioned.

This study uses a dummy variable for industry variable, with the value of 1 assigned for financial industry and 0 for non-financial industry.

4.3.5. Sample Data Collection

The sample data of this study is secondary by nature because it is gathered from annual reports and financial statements of all listed companies in the Indonesian capital market, between 2007 and 2010. The starting period is 2007 because the revised Indonesian corporate governance principles were introduced in 2006 as a follow-up action to the issuance of the OECD Corporate Governance Principles in 2004. It was expected that by 2007, all the requirements of the Principles would be fulfilled and implemented effectively by companies, especially listed public companies.

In the Indonesian setting, listed public companies are pioneers in relation to good corporate governance and disclosure practices. Compared to non-listed public companies, they are more transparent, demonstrate a higher awareness of international best practices and are under rigorous supervision in implementing rules and regulations (Tabalujan 2002).

The data on corporate governance attributes and the occurrence of sanctions are collected in a sequential fashion to capture the effect of corporate governance in place before any incidence of sanctions or non-incidence of sanctions. Hence, the dependent variables (incidence of sanctions) were collected in a period (a year) following the observed corporate governance variables. The period of observation for corporate governance variables is 2007–2010. Hence, the incidence of sanctions data were collected for the period 2008–2011 (that is, for the same number of years, but lagging one year behind the governance variables collection period). The data set is likely to be unbalanced, as the study focuses on sanctioned firms, the number of which varies from year to year.

Corporate governance attributes data for listed public companies in Indonesia are obtained from annual reports and financial statements. The sanctions data (including any appeals, if any) were sourced from Bapepam-LK only, as documented on their website and in their annual reports and press releases for the relevant period.

4.3.6. Methodology

This study uses a quantitative research approach in which an inferential statistic methodology is applied to provide empirical evidence of the relationships between selected corporate governance attributes and the incidence of sanctions.

The descriptive statistics on selected corporate governance attributes were prepared to highlight the nature of current corporate governance practice in Indonesia. This investigation then followed by empirical analyses of the relationships between corporate governance variables and the incidence of sanctions as identified under the specific aims of this study. Addressing these objectives will generate a model that elaborates the relationships and predicts the probability of the occurrence of sanctions based on a given set of corporate governance variables. The method used to achieve these objectives is multiple logistic regression of pooled data.

As the dependent variable (the incidence of sanctions) is a binary or dichotomous variable, the regression model should not be estimated using a linear probability model (LPM) with the least-squares method. A special model is required, such as a logit or probit regression model with a *maximum likelihood* (ML) method (Gujarati 2011). There are several reasons that a LPM with least-squares method is not suitable for use with a binary dependent variable regression method (Gujarati 2011). First, the LPM assumes that the probability of the dependent variable (that is, the probability of the incidence of sanctions) moves linearly with the value of the independent variables, without considering the size of the value. Secondly, the probability of the dependent variable should have a value between 0 and 1. However, the LPM does not guarantee that the estimated probability will fall within this value. The result could be greater than 1 or even negative (less than 0). Thirdly, the assumption of error term as normally distributed does not hold if the dependent variable values only consist of 1 or 0. Lastly, the error term in the LPM is heteroscedastic, making traditional significance tests suspect.

Based on the above limitations, the logistic regression model (either a logit or probit model) is the appropriate method for binary or dichotomous dependent variables (the incidence of being sanctioned or not sanctioned). Further, as mentioned, the data set is likely to be unbalanced between sanctioned and non-sanctioned firms and vary from year to year. The logistic regression model is suitable for disproportionate sampling (Maddala 1991). There is an alternative method for analysing classification between two choices of dependent variable, which is known as discriminant analysis. However, Press and Wilson (1978, as cited in Kennedy 2003) argue that logit model is superior compare to discriminant analysis due to unreasonable assumption of multivariate-normally distribution in discriminant analysis.

Logit and probit models generally generate similar results, with the use of a conversion factor of about 1.81 to make probit coefficients directly comparable with logit coefficients. However, researchers tend to choose the logit model rather than the probit model because of its comparative mathematical simplicity (Gujarati 2011).

The logit model estimates the probability of the occurrence of a binary dependent variable given the values of the explanatory variables. To develop the model, there are two conditions that have to be satisfied (Gujarati 2011). First, any changes in the explanatory variables should give an estimated probability of the binary dependent variable between 0 and 1. Second, the relationship between the estimated probability of the dependent variable and the explanatory variables is not linear, in which the predicted probability approaches zero at slower and slower rate when explanatory variables get small, and predicted probability approaches one at slower and slower rate when explanatory variables get bigger. It creates a sigmoid cumulative logistic distribution function.

The logit model of multiple logistic regression is as follows:

$$L_i = ln\left(\frac{p_i}{1-p_1}\right) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \ldots + \beta_n X_i + \varepsilon_i$$

Where p_i is the probability of observing a value of 1 for the dependent variable. This may also be referred to as the probability of 'success'.

The relationship between corporate governance variables and the incidence of sanctions will be investigated using the logistic regression model. The selected corporate governance attributes are the independent variables of the model. The dependent variable of the model is incidence of sanctions, which will take the value of 1 if a company is being sanctioned in a particular year, and 0 otherwise (dummy variable). This model will measure the likelihood of a company being sanctioned (regardless of level of sanctions) based on a set of selected corporate governance variables. The estimated form of the multiple logistic regression model in this study is:

$$L_i \text{ IOS} = \ln (pi/(1-pi)) = \beta_0 + \beta_1 \text{ OSTop}_i + \beta_2 \text{ OSBlock}_i + \beta_3 \text{ OSBoard5Percent}_i + \beta_4 \text{ BoCIndSize}_i + \beta_5 \text{ BoCSizeClass}_i + \beta_6 \text{ BoCMeetFreq}_i + \beta_7 \text{ ACExpSize}_i + \beta_8 \text{ ACMeetFreq}_i + \beta_9 \text{ EAQual}_i + \beta_{10} \text{ AssetClass}_i + \beta_{11} \text{ AgeClass}_i + \beta_{12} \text{ Industry}_i$$

Where:

IOS: The Incidence of Sanction (= 1 if the observed company is sanctioned, = 0 otherwise)

OSTop: Top Shareholder, the percentage of shares held by the biggest (top) shareholder

OSBlock: Block-holders, the number of block-holders (shareholders, either individual or institutional) having 5% or more ownership in the company

OSBoard5Percent: Ownership by Board, the number of board of commissioners or board of directors members that own 5% or more of company shares.

BoCIndSize: Board of Commissioners Independency, the proportion of independent commissioners

BoCSizeClass: Board of Commissioners Size, the number of members on the board of commissioners

BoCMeetFreq: Board of Commissioners Meeting, the frequency with which the board of commissioners meets in a year

ACExpSize: Audit Committee Expert, the proportion of audit committee members that have an academic or work experience background in accounting or finance

ACMeetFreq: Audit Committee Meeting, the frequency with which the audit committee meets in a year

EAQual: External Auditor Quality, using the proxy of Big 4 accounting firm (= 1 if the firm is one of the Big 4, = 0 otherwise)

AssetClass: Company Size, size of company as measured by total assets at the end of the financial period

AgeClass: Listing Age, years a company has been listed on the stock exchange

Industry: Industry Types, the type of industry, whether financial or non-financial (= 1 if financial industry, = 0 otherwise)

p_i is the probability of the i^{th} company being sanctioned; ln is the natural log.

Table 4.2 summarises the hypotheses, their corresponding independent variables and related measurement scales.

Table 4.2 Summary of Hypotheses and the Corresponding Independent Variables

Hypotheses		Independent Variables	Measurement Scale	Value and Criteria
H1	Top Shareholders has a negative relationship with the incidence of sanctions	OSTop	Ratio	-
H2	Number of Block-holders has a positive relationship with the incidence of sanctions	OSBlock	Ratio	-
H3	Ownership by Board has a negative relationship with the incidence of sanctions	OSBoard5Percent	Categorical	0 = Board members own less than 5% 1 = Board members own 5% or more
H4	Board Independency has a negative relationship with the incidence of sanctions	BoCIndSize	Categorical	1 = 0–1/3 (One-third size) 2 = more than 1/3–2/3 (Two-third size) 3 = more than 2/3–1 (Full size)
H5	Board Size has a positive relationship with the incidence of sanctions	BoCSizeClass	Categorical	1 = 0–4 members (Small) 2 = 5–8 members (Medium) 3 = more than 8 members (Large)
H6	Board Meeting has a negative relationship with the incidence of sanctions	BoCMeetFreq	Categorical	1 = 0–3 meetings (Least frequent) 2 = 4–12 meetings (Frequent) 3 = more than 12 meetings (More frequent)
H7	Audited Committee Expertise has a negative relationship with the incidence of sanctions	ACExpSize	Categorical	1 = 0–1/3 (One-third size) 2 = more than 1/3–2/3 (Two-third size) 3 = more than 2/3–1 (Full size)
H8	Audited Committee Meeting has a negative relationship with the incidence of sanctions	ACMeetFreq	Categorical	1 = 0–3 meetings (Least frequent) 2 = 4–12 meetings (Frequent) 3 = more than 12 meetings (More frequent)
H9	External Auditor Quality has a negative relationship with the incidence of sanctions	EAQual	Categorical	0 = Non-Big 4 1 = Big 4

4.3.7. Multiple Logistic Regression

Regression methods in statistics are used to analyse the relationship between a response variable and one or more explanatory variables. Response variables are also known as outcome or dependent variables, while explanatory variables are independent, predictor or covariate variables. In the case of logistic regression, the response variable is a discrete rather than continuous value, taking only one of two possible values, such as ‘yes’ or ‘no’, ‘happening’ or ‘not happening’ and so forth. This is an example of a dichotomous variable, which generate a binary response (for example, a 0 value is assigned for a ‘no’ response, and 1 for a ‘yes’ response) (Hosmer & Lemeshow 2000).

In using the logistic regression model, some terms and concepts related to probability should be understood, for example, odds, odds ratio and log of odds (logit). To serve as the basis for an explanation of these concepts, Table 4.3 below provides an extract of the sample data from the study.

Table 4.3 The Incidence of Sanctions by External Auditor Quality

Description			The Incidence of Sanctions		Total
			Not sanctioned	Sanctioned	
External Auditor Quality	Non-Big 4	Frequency	499	236	735
		Percentage	68	32	100
	Big 4	Frequency	351	119	470
		Percentage	75	25	100
Total		Frequency	850	355	1205
		Percentage	71	29	100

Using the data in Table 4.3, the dependent variable is the incidence of sanctions, whereas the independent variable is EA quality. Both variables are coded with binary values to reflect the situation. From the table, the proportion of companies being sanctioned is 29.46%. Equivalently, the *probability* of being sanctioned is 0.2946.

As *proportion* or *probability* refers to the likelihood of a specific event occurring compared to the total sample/population, another concept expresses the likelihood of the event in the logistic regression. The term *odds* refers to the likelihood of an event occurring compared relatively to an event not occurring. In the sample used in this study, and shown in Table 4.3 above, from a total 1205 companies, 850 companies are not sanctioned, while 355 companies are sanctioned. The *odds* of a company being a sanctioned company is 0.4176 (355/850), meaning that if a random company is chosen from the sample, that company will be 0.4176 times more likely to be sanctioned than not sanctioned. Another way to calculate the *odds* is based on the probability formula:

odds = p / (1-p)

As mentioned previously, the probability of being sanctioned is 0.2933. Therefore, the *odds* of being sanctioned is p / (1-p) = 0.2946 / (1-0.2946) = 0.2946 / 0.7054 = 0.4176.

The above *odds* calculation is for *unconditional odds*, meaning the *odds* of the whole sample without considering other variables (for example, EA quality). *Conditional odds* measure the likelihood of an event occurring compared to an event not occurring, subject to certain conditions. For example, the *conditional odds* of being sanctioned depending on EA quality (the explanatory variable) are as follows:

Using a non-Big 4 auditor *odds* of being sanctioned = 0.3211 / (1-0.3211) = 0.4729

Using a Big 4 auditor *odds* of being sanctioned = 0.2532 / (1-0.2532) = 0.3390

Another useful term is *odds ratio*, which directly compares the odds of one condition to another, depending on the baseline comparison. Based on the example in Table 4.3, the *odds ratio* of Big 4 auditor compared to non-Big 4 auditor is 0.7885 (with non-Big 4 auditor as a baseline), whereas the *odds ratio* of non-Big 4 compared to Big 4 auditor is 1.2682 (with Big 4 auditor as a baseline). The *odds ratio* of Big 4 auditor of 0.7885 means that companies using a Big 4 auditor are about 0.8 times as likely as companies employing a non-Big 4 auditor to be sanctioned. Conversely, the *odds ratio* of non-Big 4 auditor of 1.2682 says that companies using a non-Big 4 auditor are about 1.2 times as likely as companies employing a Big 4 auditor to be sanctioned. Thus, companies using a Big 4 auditor are less likely to be sanctioned compared to companies using a non-Big 4 auditor (0.8 times in comparison), while companies employing a non-Big 4 auditor are more likely to be sanctioned compared to companies using a Big 4 auditor (1.2 times in comparison).

An *odds ratio* value of 0 to just below 1 means that the event is *less likely* to happen in comparison to the baseline group. An *odds ratio* of 1 indicates that the event is *exactly as likely* to happen in both groups. An *odds ratio* value of just above 1 to infinity implies that the event is *more likely* to happen in comparison to the baseline group.

There is a problem in using *odds ratio* directly in modelling because they are asymmetric. To eliminate this problem, it is advised to take the ‘log’ of the *odds*. The log of the *odds* (logit) makes the relationship symmetrical around zero. Hence, taking the log to both equation models would create a general equation model in logistic regression as follows:

$$\ln [p/(1-p)] = a + b_1x_1 + b_2x_2 + b_3x_3 + \ldots +b_nx_n$$

or:

$$\ln [p/(1-p)] = a + bx$$

This log *odds* equation shows the relationship between explanatory variables and the log of the odds of an event occurring. Further, this logistic function could be transformed into a measurement of predicted probabilities of an event occurring based on explanatory variables, as reflected in the equation.

The first step is to take the reverse of the log (called as exponential or anti-logarithm) to both sides of the equation, so the *odds* can be expressed as:

$$\frac{p}{1-p} = e^{a+bx}$$

Second, re-arrange the equation using simple algebra to get the value of p (probabilities):

$$p = \frac{e^{a+bx}}{1+ e^{a+bx}}$$

This equation shows how to compute the predicted probability of an event occurring based on the explanatory variables given in the model. By transforming the log of the *odds* into a predicted probabilities model, the logistic regression could serve as a predictive model for a dichotomous dependent variable (an event occurring or not occurring), based on the explanatory variables developed in the model.

4.4. Summary

This chapter discussed the factors and the corresponding variables influencing corporate governance and the incidence of sanctions in the Indonesian capital market. The Indonesian corporate governance implementation is measured using four major groups of attributes as proxies: OS, BoC, AC and EA. Each factor is further elaborated into some specific observable attributes, and the choice of variables and the measurement scales selected are justified. The chapter also presented the conceptual framework and the hypotheses tested by the study, followed by a detailed discussion of the logistic regression model employed to estimate the parameters.

The next chapter will discuss the descriptive statistics of the variables, followed by a discussion of the model results and their interpretations with respect to the study objectives and the research question.

Chapter 5: Analysis and Discussion of Results

5.1. Introduction

This chapter presents the analysis and discussion of the results of the study in two parts, followed by the conclusions. Section 5.2 presents the descriptive statistics of the sample. Section 5.3 presents the estimates of the logit model and discusses the outcomes of the hypotheses tests. Finally, Section 5.4 gives the conclusions for each objective of the study.

5.2. Descriptive Statistics

This section explores the descriptive statistics of the sample data and all variables discussed in Chapter 4. It starts with the descriptive statistics of the collected sample data set and all the variables. This descriptive analysis is the initial investigation of the data before applying the model to test the hypotheses and make inferential findings about the research.

5.2.1. Sample Data Set

The observation period for this study was 2007–2010. As explained in Chapter 4, corporate governance attributes as independent variables were observed for the period of observation, while the sanction determinations as the dependent variable were usually traced to the following period. This sequential observation approach was taken to capture the effect of the implementation of corporate governance in a specific year on the incidence of sanctions.

During the period 2007–2010, 1205 observations of listed companies were made, including 850 cases with no incidence of sanctions and 355 cases with an incidence of sanctions. The sample constitutes 74% of the population, providing excellent representation. Table 5.1 shows the distribution of the sample over the study period.

Table 5.1 Distribution of the Sample

Year	Listed Company		Percentage Observed (Sample)
	Total Observed	Total Listed IDX	
2007	275	391	70.33%
2008	314	399	78.70%
2009	320	412	77.67%
2010	296	422	70.14%
TOTAL	**1205**	**1624**	**74.20%**

Companies listed on the IDX are categorised into nine industry sectors. Table 5.3 shows the detailed distribution of the sample based on industry sector. As shown in the table, the average sample size for each industry per year across the four years of observation was mostly above 63% of the population. However, for two industry sectors in 2010; that is, the Mining and Basic Industry and Chemicals sectors, the samples represent only 55% and 47% of the population, respectively. This is owing to incomplete corporate governance data for the sector for 2010. On average, the sample size for each sector across the four years of observation was above 69% of the population.

Table 5.2 below presents the sample data set for industry sector, based on non-financial and financial industry.

Table 5.2 Distribution of the Sample Based on Non-Financial versus Financial Industry

Industry	**Year**								**TOTAL**	
	2007		**2008**		**2009**		**2010**			
	Obs	**%**	**Obs**	**%**	**Obs**	**%**	**Obs**	**%**	**Obs**	**%**
Non-Financial	173 (236)	73%	201 (245)	82%	201 (254)	79%	177 (258)	69%	752 (993)	76%
Financial	102 (155)	66%	113 (154)	73%	119 (158)	75%	119 (164)	73%	453 (631)	72%
Total	**275 (391)**	**70%**	**314 (399)**	**79%**	**320 (412)**	**78%**	**296 (422)**	**70%**	**1205 (1624)**	**74%**

On average, across the four years of observation, the sample size for the non-financial industry is 76% of the population; while for the financial industry, the sample size is 72% of the population.

Table 5.3 Distribution of the Sample over Industry Sector and Study Period

Industry	Year												TOTAL		
	2007			2008			2009			2010					
	Listed	Obs	% Obs	Listed	Obs	% Obs	Listed	Obs	% Obs	Listed	Obs	% Obs	Listed	Obs	% Obs
1	14	9	64%	14	11	79%	15	14	93%	15	11	73%	58	45	78%
2	14	11	79%	21	16	76%	23	17	74%	29	16	55%	87	60	69%
3	57	45	79%	57	48	84%	59	46	78%	59	28	47%	232	167	72%
4	46	33	72%	47	35	74%	45	34	76%	42	32	76%	180	134	74%
5	36	24	67%	35	28	80%	35	26	74%	34	26	76%	140	104	74%
6	45	29	64%	45	39	87%	46	40	87%	47	40	85%	183	148	81%
7	24	22	92%	26	24	92%	31	24	77%	32	24	75%	113	94	83%
8	69	48	70%	68	55	81%	69	54	78%	70	51	73%	276	208	75%
9	86	54	63%	86	58	67%	89	65	73%	94	68	72%	355	245	69%
Total	**391**	**275**	**70%**	**399**	**314**	**79%**	**412**	**320**	**78%**	**422**	**296**	**70%**	**1624**	**1205**	**74%**

Industry Code
1. Agriculture *
2. Mining *
3. Basic Industry and Chemicals *
4. Miscellaneous Industry *
5. Consumer Goods Industry *
6. Property, Real Estate and Building Construction *
7. Infrastructure, Utilities and Transportation *
8. Finance **
9. Trade Service and Investment **

** Non-Financial Sector Industry*
*** Financial Sector Industry*

Table 5.4 presents the yearly distribution of sanctioned and non-sanctioned firms over the sample period.

Table 5.4 Distribution of Sanctions over the Sample Period

Dependent Variable	Year				TOTAL
	2007	2008	2009	2010	
Non-sanctioned	206	189	240	215	850
Sanctioned	69	125	80	81	355
Total Sample	**275**	**314**	**320**	**296**	**1205**
Percentage Sanctioned	25.00%	39.68%	25.00%	27.36%	29.46%

For the period of observations, about 70.54% or 850 companies within the sample were not sanctioned, while about 29.46% or 355 companies were sanctioned during the sample period. A detailed discussion of the dependent variable will be presented in Section 5.2.2.6.

5.2.2. Variables

The following section provides detailed descriptive statistics for all variables included in the study. The variables are categorised into six groups: OS, BoC, AC, EA, control variable and incidence of sanctions.

5.2.2.1. Ownership Structure Variables

OS incorporates the variables of Top Shareholder (OSTop), Number of Block-holders (OSBlock) and Ownership by Board (OSBoard5Percent).

Top Shareholder (OSTop)

Table 5.5 below presents share ownership (as a percentage) by top shareholders in the sample data.

Table 5.5 Distribution of Shares Ownership by Top Shareholders

Share Ownership	Sample Frequencies		Cumulative	
	Freq	%	Freq	%
0–20%	89	7.39	89	7.39
> 20–40%	349	28.96	438	36.35
> 40–60%	356	29.54	794	65.89
> 60–80%	285	23.65	1079	89.54
> 80–100%	126	10.46	1205	100.00
TOTAL	**1205**	**100.00**	**1205**	**100.00**

The OSTop variable shows individual top shareholders that own the largest percentage of shares in a firm. This variable, obtained from the equity section of company reports, explains direct ownership, or simple OS. However, this OS does not necessarily reflect the ultimate ownership of the company through complex OS. The top shareholder may be an individual or organisation; this study does not identify types of holder.

As shown in Table 5.5, most top shareholders (29.54%) own 40–60% of shares, followed by 28.96% of top shareholders who own 20–40% of shares, and 23.65% of top shareholders who own 60–80% of shares.

To investigate ownership percentage of top shareholders further, a 50% ownership cut-off is used to categorise shareholders' holdings in Table 5.6.

Table 5.6 Top Shareholder Ownership Classification with 50% Ownership Cut-off

Top Share Ownership	Sample Frequency	
	Freq	**%**
0–50%	563	46.72
> 50%–100%	642	53.28
Total	**1205**	**100.00**

Table 5.6 shows that most top shareholders in Indonesia (53.28%) own shares of more than 50% of total shares of a listed company. Despite only showing direct ownership, this finding confirms the concentrated OS of Indonesian-listed companies.

The average share ownership of top shareholders is 50.36%, while the median is 51.06%. Further, the minimum percentage held by top shareholders is 1.52%, while the maximum ownership is 99.99%. These statistics reveal that direct ownership of listed companies in Indonesia is roughly normally distributed. However, based on the 50% cut-off, 53.28% of individual top shareholders own more than 50% of company shares individually.

This concentration of ownership as direct ownership only reflects the situation in which CFR is equal to CR according to the 'one share–one vote' principle. However, as explained by Claessens, Djankov and Lang (2000) and Adams and Ferreira (2008), there are conditions that lead to disproportional ownership (where CFR are less than CR), such as through a pyramid structure, dual class shares and cross-ownership. Based on the Indonesian Company Law of 2007, dual class shares and cross ownership is prohibited. Hence, disproportional ownership is usually achieved through a pyramid structure. Where this happens, there is an additional concentration of ownership beyond the current distribution. Hence, this study concludes that concentration of ownership is prominent in the Indonesian capital market.

Number of Block-holders (OSBlock)

Table 5.7 shows number of block-holders in a listed company and their frequency in the sample data. This statistic is intended to measure the various parties (interests) of controlling shareholders and the effect of their competition to control the company on management performance.

Table 5.7 Distribution of Number of Block-holders

Number of Block-holders	Sample Frequency	
	Freq	%
1	342	28.38
2	326	27.05
3	250	20.75
4	132	10.95
5	89	7.39
6	49	4.07
7	15	1.24
8	2	0.17
Total	**1205**	**100.00**

The OSBlock variable reflects the number of individual shareholders that own 5% or more of company shares, including top shareholders. As shown in Table 5.7, single blockholders; that is, top shareholders, are dominant in the sample, comprising 342 companies, or 28.38% of the sample.

Table 5.8 below presents cross-tabulation data between Top Shareholders with 50% ownership cut-off and Number of Block-holders. It shows that from 342 companies that have single block-holders (that is, top shareholders only), in 297 companies (86.84%) the single block-holder owns more than 50% of company shares. In other words, 24.65% of listed companies are directly owned by single shareholders that own more than 50% of stakes. This is the dominant condition in the sample of 1205 listed companies. Second to this are companies with two block-holders, where the top shareholder holds more than 50% of shares. This condition applies to 211 companies, or 17.51% of the sample size.

Table 5.8 also shows that although multiple shareholders exist in the Indonesian-listed companies, 642 companies with multiple shareholders have top shareholders that own more than 50% of shares. This further highlights the degree of concentration of ownership by top shareholders of Indonesian-listed firms. This situation could endanger the interests of small shareholders.

These statistics further confirm that in the majority of listed companies in Indonesia, ownership is concentrated in the hands of a single top shareholder that owns more than 50% of stakes, even though there are multiple block-holders in place. In addition, as many Indonesian public companies are categorised as family businesses (Claessens, Djankov & Lang 2000), it is possible that some of these non-top block-holders are in fact also part of the controlling family or are affiliated with it. If that is the situation, the effectual concentration of ownership could be higher than is indicated by the data.

Table 5.8 Cross Tabulation between Number of Block-holders and Top Share Ownership with 50% Ownership Cut-off

			OSBlock (number of block-holders)								**Total**
			1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	
OSTop (%)	**0–50**	Freq	45	115	161	96	85	44	15	2	563
		%	3.73	9.54	13.36	7.97	7.05	3.65	1.24	0.17	46.72
	>50–100	Freq	297	211	89	36	4	5	0	0	642
		%	24.65	17.51	7.39	2.99	0.33	0.41	0.00	0.00	53.28
Total		Freq	342	326	250	132	89	49	15	2	1205
		%	28.38	27.05	20.75	10.95	7.39	4.07	1.24	0.17	100.00

Ownership by Board (OSBoard5Percent)

Where members of the BoC or BoD own shares in the company, they are considered insiders and are expected to carry a higher burden towards avoiding any conflicts of interest in fulfilling their obligation as officers of the company. Therefore, board members owning shares should have a positive impact on company performance. Table 5.9 below shows the distribution of share ownership by board members within the sample data set.

Table 5.9 Distribution of Ownership by Board

Value	Freq	%
Board members own less than 5%	1048	86.97
Board members own 5% or more	157	13.03
Total	**1205**	**100.00**

The OSBoard5Percent variable identifies the number of board members that own 5% or more of company shares. The table above finds that in only 157 companies, or 13.03% of the sample size, did board members hold 5% or more shares in the company. This is not a significant number, and compared to the strength of concentration of ownership by top shareholders, the small 5% owned by board members is not likely to have any real impact.

5.2.2.2. Board of Commissioner Variables

Examining the distribution of certain BoC variables provides some insight into the two-tier board structure in Indonesia, especially as concerns the advantage of the board as an independent supervisory board. The three variables included as measures of BoC composition are Board Independency (BoCIndSize), Board Size (BoCSizeClass) and Board Meeting (BoCMeetFreq).

Board Independency (BoCIndSize)

Table 5.10 presents the relative size distributions for independent member composition of BoC for the sample data.

Table 5.10 Size Distribution of Independent Board

Value	Sample Frequency	
	Freq	**%**
0–1/3 (One-third size)	566	46.97
more than 1/3 to 2/3 (Two-third size)	607	50.37
more than 2/3 (Full size)	32	2.66
Total	**1205**	**100.00**

As BoC size varies among corporations, to compare the numbers of independent members on the BoC, independent members were measured relative to the size of the board. Three categories of size were used, being one-third, two-thirds or fully composed of independent members. The data shows that 50.37% of listed companies had a BoC composed of two-thirds independent board members, followed by 46.97% of companies with one-third independent members. This shows that, based on their company reports, most of the companies in the sample were in compliance with the legal requirement to have a minimum of one independent commissioner on their BoC (The Republic of Indonesia 2007).

Further, the finding that the majority of listed companies (50.37%) have two-thirds independent BoC members illustrates the independent nature of the BoC's monitoring process. This reinforces the independent function of the BoC in the two-tier board system.

Board Size (BoCSizeClass)

Table 5.11 shows the size distributions of the BoCs of the listed companies in the sample.

Table 5.11 Size Distribution of Board of Commissioners

Value	Sample Frequency	
	Freq	%
0–4 members (Small)	747	61.99
5–8 members (Medium)	412	34.19
more than 8 members (Large)	46	3.82
Total	**1205**	**100.00**

With regard to the size of BoC (BoCSizeClass), the study categorises board size into three groups (small, medium and large) based on the number of board members. The majority of listed companies in the sample had small BoCs (747 companies, or 61.99% of the sample size), followed by medium size boards (412 companies, or 34.19% of the sample size). This dominance of the small board size condition reflects the separation of the monitoring role and managerial role of boards in the two-tier board system. In the one-tier board system, boards tend to be larger because they have to accommodate the two functions in a single body.

Board Meeting (BoCMeetFreq)

The activeness of the BoC in monitoring management is generally captured through the frequency with which the board meets. Table 5.12 shows the summary statistics of frequency of BoC meeting in a year within the sample period.

Table 5.12 Distribution of Board Meeting Frequency

Value	Sample Frequency	
	Freq	%
0–3 meetings (Least frequent)	283	23.49
4–12 meetings (Frequent)	835	69.29
more than 12 meetings (More frequent)	87	7.22
Total	**1205**	**100.00**

The BoCMeetFreq variable classifies board meeting frequency into three categories—least frequent, frequent and more frequent—based on certain criteria. From the sample data set, 835 companies or 69.29% of the sample met frequently, while 283 companies or 23.49% of the sample arranged meetings less frequently.

5.2.2.3. Audit Committee Variables

The AC attributes are measured by two variables: AC Expertise (ACExpSize) and AC Meeting (ACMeetFreq).

Audit Committee Expertise (ACExpSize)

Table 5.13 below summarises the proportion of AC members classes as having expertise for each listed company. Again, the relative categories of one-third, two-thirds and fully composed of this category of member are used.

Table 5.13 Size Distribution of Audit Committee Expertise

Value	Sample Frequency	
	Freq	**%**
0–1/3 (One-third size)	299	24.81
more than 1/3–2/3 (Two-third size)	371	30.79
more than 2/3–1 (Full size)	535	44.40
Total	**1205**	**100.00**

The sample shows that for 535 listed companies or 44.40% of the sample their ACs were fully composed of members possessing accounting or financial backgrounds. An additional 371 companies (30.79%) and 299 companies (24.81%) had ACs that were two-thirds and one-third comprised of expert members, respectively.

The fact that most ACs in the sample data were either fully or two-thirds comprised of members having relevant expertise (44.40% and 30.79% of the sample size, respectively) gives further confidence that this organ can perform its roles effectively. In addition, the regulator requires that all AC members should be independent. This combination of member independency and expertise would greatly benefit corporate governance effectiveness.

Audit Committee Meeting (ACMeetFreq)

Table 5.14 presents the descriptive statistics for AC meeting frequency from the sample data.

Table 5.14 Distribution of Audit Committee Meeting Frequency

Value	Sample Frequency	
	Freq	%
0–3 meetings (Least frequent)	516	42.82
4–12 meetings (Frequent)	587	48.71
more than 12 meetings (More frequent)	102	8.46
Total	**1205**	**100**

Similar to BoC meeting frequency, AC meeting frequency shows that the majority of listed companies (48.71% of the sample, or 587 companies) organised AC frequent meetings, while 42.83% of the sample or 516 companies had AC meetings on a least frequent basis. Only 8.46% of the sample or 102 companies arranged AC meetings more frequently.

5.2.2.4. External Auditor Variable

The EA is expected to have a significant role in mitigating conflicts of interest between shareholders and management and between controlling shareholders and minority shareholders by providing independent and professional financial reports to all parties (Fan & Wong 2005). One proxy by which to measure EA quality is whether the auditor is one of the Big 4 firms.[16] Table 5.15 presents the classification of the EA used by the listed companies in the sample data, based on whether it is one of the Big 4.

Table 5.15 Use of Accounting Firms

Value	Sample Frequency	
	Freq	%
Non-Big 4	735	61.00
Big 4	470	39.00
Total	**1205**	**100.00**

Table 5.15 shows that most of the listed companies in the sample (735 companies or 61%) were audited by Non-Big 4 firms. The remaining 470 companies (or 39% of the sample size) were audited by Big 4 auditors.

[16] See Section 2.6.3 for an explanation of the Big 4.

5.2.2.5. Control Variables

AssetClass

Table 5.16 below classifies the listed companies in the sample into three categories based on total asset size at the end of financial year within the sample period.

Table 5.16 Distribution of Asset Size

Value	Sample Frequency	
	Freq	**%**
0–1 Trillion Rupiah (Small)	535	44.40
more than 1 Trillion Rupiah–10 trillion Rupiah (Medium)	505	41.91
more than 10 trillion Rupiah (Large)	165	13.69
Total	**1205**	**100.00**

In terms of company size, this study classifies listed companies into small, medium and large companies based on their asset size at the end of financial year. The sample data shows that the proportion of small and medium listed companies is almost equal (535 companies or 44.40% of the sample, and 505 companies or 41.91% of the sample, respectively). Only 165 companies in the sample (13.69%) were considered large.

AgeClass

Table 5.17 presents the classification of the listed companies in the sample based on the period since their first listing on the stock exchange.

Table 5.17 Distribution of Listing Period

Value	Sample Frequency	
	Freq	**%**
1–10 years (Young)	469	38.92
11–20 years (Mature)	667	55.35
more than 20 years (Old)	69	5.73
Total	**1205**	**100.00**

The sample data shows that more than half of the listed companies (667 companies or 55.35% of the sample) were mature, followed by young companies (469 companies or 38.92% of the sample). Only 69 companies (or 5.73% of the sample) were categorised as old.

Industry

There are two major classifications for industry group within the sample data: non-financial and financial. Table 5.18 gives the descriptive statistics for the industry variable.

Table 5.18 Distribution of Industry Classification

Industry Class	Sample Frequency	
	Freq	%
Non-financial Industry	997	82.74
Financial Industry	208	17.26
Total	**1205**	**100.00**

The sample data mostly consists of companies in the non-financial industry (997 companies or 82.74%), with only 208 companies (17.26%) being from the financial industry.

5.2.2.6. Dependent Variable

The sample data for the dependent variable is presented in Table 5.4. This section further elaborates the sanctions given to the listed companies in the sample period according to level (that is, Level 1–4). Table 5.19 presents the sample data for sanctioned and non-sanctioned companies with further details on the level of sanctions received.

Table 5.19 Distribution of Sanctions Level

Dependent Variable	Year				TOTAL
	2007	2008	2009	2010	
Non-sanctioned	206	189	240	215	850
Sanctioned *	69	125	80	81	355
Level 1	0	0	0	12	12
Level 2	69	125	80	69	343
Level 3	0	0	0	0	0
Level 4	0	0	0	0	0
Total	**275**	**314**	**320**	**296**	**1205**
Percentage Sanctioned	25.00%	39.68%	25.00%	27.36%	29.41%

* As explained in Section 4.3.2, this study only looked at sanction levels up to 4, as level 5 is criminal proceedings, with the sanction being far from definite due to being determined by a court and subject to appeal. Investigating this level here was thus not practicable. Level 1 = Letter of Notice; Level 2 = Fines; Level 3 = Limitation of Activities, Freezing of Activities; Level 4 = Revocation of License, Cancellation of Approval, Cancellation of Registration Statement.

The sample data set shows that on average about a third (29%) of companies are sanctioned in a given year. However, a significant number of sanctions were given in 2008 (about 40% of the total sample). This situation stems from the global financial crisis in 2007–2008, which also affected the Indonesian economy, including the capital market. The global crisis affected the regulatory compliance of listed companies, where many may have prioritised their business sustainability over some aspects of compliance.

The table also shows the various levels of sanctions of the sanctioned firms. Almost all of the sanctions are at Level 2, Fines. Only a few sanctions fall in the Level 1 category, Letter of Notice. None of the 355 sanctions were at Level 3 or 4.

These conditions are caused by a range of factors. First, this study records sanctions based on the highest level of sanction received, ignoring the lower level sanctions if multiple sanctions are received by firms. For example, if a listed company receives both a Level 1 and Level 2 sanction in a given period, this will be classified as Level 2, without considering the Level 1 sanction.

Secondly, Bapepam-LK tends to favour administrative sanctions, especially Level 2, Fines. This condition has been observed by the World Bank and the IMF in their ROSC 2004. They urge Bapepam-LK as the regulator to go beyond administrative sanctions (fines) as enforcement (World Bank & IMF 2004). Specifically, any misconduct or fraud should be investigated as in need of possible criminal sanctions, rather than merely imposing substantial fines on wrongdoers. However, this preference for administrative sanctions on the part of Bapepam-LK is justified, as criminal proceedings are expensive and lengthy under the current Indonesian criminal law regime (World Bank and IMF 2010). Instead, Bapepam-LK tends to focus on heavy monetary fines, including for groups of listed companies, to act as a deterrent (Bapepam-LK 2010).

With regard to Level 3 and 4 sanctions, while they were not observed for the listed companies in the sample data, these levels of sanction were given on occasion to capital market professionals, such as auditors and appraisers, rather than directly to listed companies.

5.3. Estimates of the Logit Model

To test the robustness of and validate the model of the relationship between corporate governance attributes and the incidence of sanctions, four approaches are used in this study.

First, prior to estimating the model parameters, the presence of multicollinearity was evaluated using a correlation matrix. Second, the study assesses the model using the *likelihood ratio test* (Hosmer & Lemeshow 2000). This test is also known as *deviance analysis* (McCullagh & Nelder 1983, as cited in Hosmer & Lemeshow 2000). The full model (with all independent variables included) and a reduced model (with significant independent variables only) are compared to determine the significance of the model.

Third, to test the predictive power of the model (that is, its ability to predict the probability of sanctions accurately), the study compared expectation–prediction evaluations. This was based on cut-off probability values. Fourth, to cross validate the model, the study adopted the data splitting technique. The sample data set was divided into two sample data periods: 2007–2009 (in-sample data) and 2010 (out-of-sample data). The variable coefficients generated from the in-sample data model were implemented towards the out-of-sample data figures to predict the probability of sanctions in 2010. The predictions were then compared with the real sanctions data for 2010 to obtain an expectation–prediction table. These steps were taken to ensure the usefulness of the estimated model.

5.3.1. Correlation Analysis

To address the concern of endogeneity that refer to endogeneity between independent variables, correlation analysis is performed to test multicollinearity problems between independent variables, as an indicator of endogeneity. One popular method to detect multicollinearity is using a correlation matrix (Kennedy 2003). The matrix shows the correlation coefficients between individual independent variables within a sample data set. Table 5.20 below shows the pairwise correlation coefficients between the individual independent variables.

The correlation matrix shows that the pairwise correlations between the independent variables are all below 0.6, with the highest value of 0.58 observed between OSBlock and OSTop. As asserted by Kennedy (2003), correlations below 0.8 are acceptable for econometric estimation purposes.

The correlation matrix has demonstrated that the pairwise correlation coefficients among the independent variables are low. Therefore, multicollinearity is not a problem with the data set.

Table 5.20 Correlation Matrix

CORRELATION COEFFICIENTS	OSTOP	OSBLOCK	OSBOARD5 PERCENT	BOCIND SIZE	BOCSIZEC LASS	BOCMEET FREQ	ACEXP SIZE	ACMEET FREQ	EAQUAL	ASSET CLASS	AGE CLASS	INDUSTRY
OSTOP	1											
OSBLOCK	-0.5839	1										
OSBOARD5PERCENT	-0.1195	0.0877	1									
BOCINDSIZE	0.0016	-0.0626	-0.0965	1								
BOCSIZECLASS	0.0156	-0.0479	-0.0738	0.1832	1							
BOCMEETFREQ	0.0225	-0.0569	-0.0037	0.1206	0.0997	1						
ACEXPSIZE	-0.0236	-0.0303	0.0418	0.0330	0.0858	0.0240	1					
ACMEETFREQ	0.0281	-0.0114	-0.0424	0.1363	0.2013	0.3158	0.1406	1				
EAQUAL	0.2256	-0.0856	-0.1649	0.0848	0.3082	0.1042	0.0609	0.2964	1			
ASSETCLASS	-0.0037	-0.1357	-0.1542	0.2933	0.4792	0.2354	0.1522	0.2932	0.3666	1		
AGE_CLASS	-0.0440	0.0730	-0.0536	-0.0242	0.0691	-0.0272	-0.0277	0.1334	0.1996	0.0701	1	
INDUSTRY	0.0383	0.0035	-0.0050	0.1611	-0.0466	0.2149	0.0197	0.1554	0.0219	0.1507	-0.0983	1

5.3.2. Likelihood Ratio Test

The *likelihood ratio test* examines the significance of the variables in the estimated model (Hosmer & Lemeshow 2000) and is based on a *log likelihood* calculation. Kleinbaum and Klein (2002) elaborate that the *likelihood ratio test* or *LR statistic* can be used to compare the significance of variables between two models, where one is reduced (smaller) and the other is full (larger). The smaller model would be a baseline model or null model (a model without variables, with constants only), while the larger model should contain more variables in comparison to the smaller model. This comparison process is also known as *deviance analysis* (McCullagh & Nelder 1983, as cited in Hosmer & Lemeshow 2000).

As the baseline model is a null model, the *LR statistic* value is the difference between *deviance* of null model less the *deviance* of full model. The lower the value of *deviance* in the full model compare to null model shows that all variables introduced in the full model have more contribution to the significance of the model. Therefore, higher *LR statistic* (*deviance* differences) would indicate a better model. Table 5.21 presents the estimates of the logistic regression model.

The output statistics show that the model has an *LR statistic* value of 83.67 (with a p-value less than 0.001, which is significant at the 1% level at least) in comparison to the null model. Hence, it is concluded that the model is significantly different from the null model. In addition, four out of the nine independent variables (OSTop, BoCSizeClass, BoCMeetFreq and ACMeetFreq) are significant at the 5% level at least. All of the control variables are significant at the 5% level at least, except for the AgeClass variable.

Table 5.21 Model Output with All Variables Included

Dependent Variable: Sanction Bppm
Method: ML - Binary Logit (Quadratic hill climbing)
Included observations: 1205

Obs with Dep=0	850
Obs with Dep=1	355
Total Obs	1205

Variable	Coefficient	Std. Error	Prob.	Exp(Coeff)
C	0.222882	0.531005	0.6747	1.249673
OSTop	-1.180698	0.377015	0.0017***	0.307064
OSBlock	-0.018854	0.053691	0.7255	0.981323
OSBoard5Percent	-0.240311	0.203447	0.2375	0.786383
BoCIndSize	-0.071176	0.126982	0.5751	0.931298
BoCSizeClass	-0.329669	0.137124	0.0162**	0.719162
BoCMeetFreq	0.325612	0.133183	0.0145**	1.384878
ACExpSize	-0.005551	0.081822	0.9459	0.994464
ACMeetFreq	-0.436265	0.118844	0.0002***	0.646446
EAQual	-0.205441	0.157777	0.1929	0.814288
AssetClass^	0.494685	0.122836	0.0001***	1.639982
AgeClass^	-0.215132	0.120531	0.0743*	0.806435
Industry^	-1.049261	0.213411	0.0000***	0.350196

* , **, *** significant at 10%, 5% and 1% level respectively
^ Control variables

McFadden R-squared	0.057272	Mean dependent var	0.294606
S.D. dependent var	0.456055	S.E. of regression	0.441976
Akaike info criterion	1.164587	Sum squared resid	232.8489
Schwarz criterion	1.219545	Log likelihood	-688.6634
Hannan-Quinn criter.	1.185285	Deviance	1377.327
Restr. deviance	1461.001	Restr. log likelihood	-730.5003
LR statistic	83.67375	Avg. log likelihood	-0.571505
Prob(LR statistic)	0.000000		

In the linear form, the output of the model as presented above could be written as:

$$L_i \text{ IOS} = \log [p/(1-p)] = 0.222882 - 1.180698 \text{ OSTop}_i - 0.018854 \text{ OSBlock}_i - 0.240311 \text{ OSBoard5Percent}_i - 0.071176 \text{ BoCIndSize}_i - 0.329669 \text{ BoCSizeClass}_i + 0.325612 \text{ BoCMeetFreq}_i - 0.005551 \text{ ACExpSize}_i - 0.436265 \text{ ACMeetFreq}_i - 0.205441 \text{ EAQual}_i + 0.494685 \text{ AssetClass}_i - 0.215132 \text{ AgeClass}_i - 1.049261 \text{ Industry}_i$$

5.3.3. Expectation–Prediction Evaluation

Despite addressing goodness of fit for the model using the *likelihood ratio test* (LR statistics) in the previous section, the study introduces an additional analysis to test the results of the fitted logistic regression model using a classification table, also known as an expectation–prediction evaluation. The classification table is an intuitively appealing way to summarise the results of a fitted logistic regression model by cross-classifying the dependent variable, y, with a dichotomous variable whose value is derived from the estimated logistic probabilities (Hosmer & Lemeshow 2000).

To obtain the dichotomous variable, a cut-off value, c, must be determined against which to compare each estimated probability. The default c value is 0.5. When the estimated probability from the fitted logistic regression model exceeds the c value, the derived variable will be equal to 1. Otherwise, it is equal to 0. Using this approach, the derived dichotomous variable is compared with the dependent variable data, to classify the prediction as either correct or incorrect.

Applying the concept of the classification table to the model, Table 5.22 presents the results of the expectation–prediction evaluation.

Table 5.22 Expectation–Prediction Evaluation Output with c = 0.5

	Estimated Equation			Constant Probability		
	Dep=0	Dep=1	Total	Dep=0	Dep=1	Total
P(Dep=1)<=C	816	315	1131	850	355	1205
P(Dep=1)>C	34	40	74	0	0	0
Total	850	355	1205	850	355	1205
Correct	816	40	856	850	0	850
% Correct	96.00	11.27	71.04	100	0	70.54
% Incorrect	4	88.73	28.96	0	100	29.46
Total Gain[1]	-4	11.27	0.5			
Percent Gain[2]	NA	11.27	1.69			

[1] Change in '% Correct' from default (constant probability) specification
[2] Percentage of incorrect (default) prediction corrected by equation

Based on the expectation–prediction evaluation output using a cut-off probability value of 0.5, the model correctly predicts 71.04% of the total observations, with 96.00% correctly predicted when the dependent variable = 0, and only 11.27% correctly predicted when the dependent variable = 1.

In relation to the determination of the cut-off value for the expectation–prediction evaluation, Neter et al. (1996) argue that there are three methods to determine this value. First, the authors suggest the standard cut-off value of 0.42. Second, the cut-off value can be determined by the best-fit predicting result obtained from trial and error observations. Third, the cut-off value could be based on proportion split of the population or sample.

Based on this argument and given the low prediction accuracy of the model using 0.5 as a cut-off value, this study selects the cut-off value based on the proportion split between dependent variable = 0 and 1. In this case, the sample data shows that 850 observations have dependent variable = 0 and 355 observations have dependent variable = 1, for the total 1205 observations. As the study is concerned with the predictive power of the model for the occurrence of sanctions (when the dependent variable = 1), the cut-off probability value is determined to be 0.3. This value is obtained by dividing the number of observations when dependent variable =1 by the total sample size (355/1205 = 0.29).

Table 5.23 shows the expectation–prediction evaluation output from the model using the cut-off probability value of 0.3.

Table 5.23 Expectation–Prediction Evaluation Output with c = 0.3

	Estimated Equation			Constant Probability		
	Dep=0	Dep=1	Total	Dep=0	Dep=1	Total
P(Dep=1)<=C	531	140	671	850	355	1205
P(Dep=1)>C	319	215	534	0	0	0
Total	850	355	1205	850	355	1205
Correct	531	215	746	850	0	850
% Correct	62.47	60.56	61.91	100	0	70.54
% Incorrect	37.53	39.44	38.09	0	100	29.46
Total Gain[1]	-37.53	60.56	-8.63			
Percent Gain[2]	NA	60.56	-29.3			

[1] Change in '% Correct' from default (constant probability) specification
[2] Percentage of incorrect (default) prediction corrected by equation

Using a cut-off probability value of 0.3, the model correctly predicts 61.91% of the observations, with 62.47% correctly predicted when dependent variable = 0 and 60.56% correctly predicted when dependent variable = 1. The implementation cut-off value 0.3 results in a significant improvement in the prediction output, with the prediction accuracy of the occurrence of dependent variable =1 increasing considerably from 11.27% to 60.56%.

5.3.4. Cross Validation

As one of the objectives of the study is to develop a model to predict the occurrence of a specific incidence, it is important to assess and validate the prediction model. Cross-validation evaluation is one method for this. It excludes a subsample of the observations, then develops a model based on the remaining subjects, and subsequently tests the model output compared to the originally excluded subjects (Hosmer & Lemeshow 2000). This approach is also known as the data-splitting technique, where the sample data will be further divided into two subsamples (subsets): in-sample data and out-of-sample data.

The steps taken to cross validate the model are as follows. A model is developed from in-sample data to produce a predictive model equation. Then, the equation from the developed model, especially the independent variable coefficients, is applied to the relevant variables of the out-of-sample data to obtain the predicted probabilities. Finally, the predicted probabilities and actual occurrences from the out-of-sample data are compared using the equation model developed previously, similar to in the expectation–prediction evaluation. This analysis determines the prediction accuracy and consistency of the developed model.

As the sample data of this study consist of the observation period 2007–2010, the data subsets are 2007–2009 (the in-sample data) and 2010 (the out-of-sample data). The model developed for the in-sample data is similar to the previous model for the full sample data. Table 5.24 presents the model estimations.

The model output for the in-sample data set also shows that four independent variables are significant at the 5% level and the model has an LR statistic value of 63.57.

The model for in-sample data could be written in logistic regression equation form as follows:

$$L_i \text{ IOS} = \log [p/(1-p)] = 0.410626 - 1.623576 \text{ OSTop}_i - 0.045384 \text{ OSBlock}_i - 0.011002 \text{ OSBoard5Percent}_i + 0.091691 \text{ BoCIndSize}_i - 0.340447 \text{ BoCSizeClass}_i + 0.319614 \text{ BoCMeetFreq}_i - 0.126899 \text{ ACExpSize}_i - 0.380095 \text{ ACMeetFreq}_i - 0.176112 \text{ EAQual}_i + 0.554544 \text{ AssetClass}_i - 0.249482 \text{ AgeClass}_i - 0.998957 \text{ Industry}_i$$

By implementing the model equation for the corresponding variables for each observation using the out-of-sample data set, the predicted probabilities for each observation were determined. Subsequently, these predicted probabilities were compared with the actual occurrences of out-of-sample data observations to compose a classification table. Then, the classification table was further analysed to assess the predictive accuracy of the model and its consistency with the previous model estimated from the whole sample.

Table 5.24 Model Output for In-Sample Data (2007–2009)

Dependent Variable: SANCTION_BPPM
Method: ML - Binary Logit (Quadratic hill climbing)
Included observations: 909

Obs with Dep=0	635
Obs with Dep=1	274
Total Obs	909

Variable	Coefficient	Std. Error	Prob.	Exp(Coeff)
C	0.410626	0.614808	0.50420	1.507761348
OSTop	-1.623576	0.449044	0.00030***	0.197192277
OSBlock	-0.045384	0.061196	0.45830	0.955630449
OSBoard5Percent	-0.011002	0.231294	0.96210	0.989058301
BoCIndSize	0.091691	0.143704	0.52340	1.096026098
BoCSizeClass	-0.340447	0.156912	0.03000**	0.711452233
BoCMeetFreq	0.319614	0.150512	0.03370**	1.376596296
ACExpSize	-0.126899	0.093904	0.17660	0.880822631
ACMeetFreq	-0.380095	0.136332	0.00530***	0.683796445
EAQual	-0.176112	0.180664	0.32970	0.838524063
AssetClass^	0.554544	0.143615	0.00010***	1.741146841
AgeClass^	-0.249482	0.14589	0.08730*	0.779204306
Industry^	-0.998957	0.238728	0.00000***	0.368263340

* , **, *** significant at 10%, 5% and 1% level respectively
^ Control variables

McFadden R-squared	0.060786	Mean dependent var	0.30143
S.D. dependent var	0.459132	S.E. of regression	0.444555
Akaike info criterion	1.178335	Sum squared resid	177.0754
Schwarz criterion	1.247158	Log likelihood	-522.5531
Hannan-Quinn criter.	1.204613	Deviance	1045.106
Rest. Deviance	1112.745	Restr. log likelihood	-556.3727
LR statistic	67.63924	Avg. log likelihood	-0.574866
Prob(LR statistic)	0.00000		

The classification table for the out-of-sample data is computed manually because the predicted probabilities are obtained from in-sample data equations and then a comparison is performed between the prediction result and actual occurrences using the equation. The classification tables for the out-of-sample data set using the two different cut-off probability values of 0.5 and 0.3 are given below in Tables 5.25 and 5.26.

Table 5.25 Expectation–Prediction Evaluation for Out-of-Sample Data with Cut-off Probability 0.5

	Estimated Equation			Constant Probability		
	Dep=0	Dep=1	Total	Dep=0	Dep=1	Total
P(Dep=1)<=C	202	65	267	215	81	296
P(Dep=1)>C	13	16	29	0	0	0
Total	215	81	296	215	81	296
Correct	202	16	218	215	0	215
% Correct	93.95	19.75	73.65	100	0	68.58
% Incorrect	6.05	80.25	26.35	0	100	31.42
Total Gain[1]	-6.05	19.75	5.07			

[1] Change in ‘% Correct’ from default (constant probability) specification

Table 5.26 Expectation–Prediction Evaluation for Out-of-Sample Data with Cut-off Probability 0.3

	Estimated Equation			Constant Probability		
	Dep=0	Dep=1	Total	Dep=0	Dep=1	Total
P(Dep=1)<=C	115	29	144	215	81	296
P(Dep=1)>C	100	52	152	0	0	0
Total	215	81	296	215	81	296
Correct	115	52	167	215	0	215
% Correct	53.49	64.20	56.42	100	0	72.64
% Incorrect	46.51	35.80	43.58	0	100	27.36
Total Gain[1]	-46.51	64.20	-16.22			

[1]Change in ‘% Correct’ from default (constant probability) specification

Table 5.25 uses the cut-off value 0.5, and shows that the in-sample data model produces a total 73.65% correct prediction (correctly predicting 93.95% for dependent variable = 0 and 19.75% for dependent variable = 1). Using a cut-off value of 0.5, this model does not produce significant predictive power, with only 19.75% correct prediction with dependent variable = 1.

Table 5.26 uses the cut-off value 0.3, and demonstrates the greater predictive power of the in-sample data model, correctly predicting 56.42% of all cases. However, it gives better prediction for dependent variable = 1 (64.20%) and dependent variable = 0 (53.49%). The prediction accuracy of the model to forecast the occurrence of dependent variable =1 is thus improved significantly (from 19.75% to 64.20%) when using the cut-off value of 0.3. This cut-off value is justified based on the proportion split of the sample (Neter et al. 1996).

These cross-validation results support the validity of the estimated model. Applying an identical model equation and the same cut-off value of 0.3 for both the full data set model and the subsample data model produces consistent prediction power. The full data model has a prediction accuracy of 60.56%, while the subsample data model has 64.20% prediction accuracy.

5.4. Discussion and Analysis

The previous sections have reviewed assessment methods to test the robustness and consistency of the model developed in this study. This model, which was built from the hypothesised relationship between corporate governance attributes and the incidence of sanctions, shows a consistent and significant accuracy in predicting the occurrence of sanctions based on the embedded corporate governance attributes of public companies.

The model output as presented in Table 5.21 shows that only four out of nine independent variables are significant at the 5% level. They are Top Shareholders (OSTop), Board Size (BoCSizeClass), Board Meeting (BoCMeetFreq) and Audit Committee Meeting (ACMeetFreq). Further, two control variables are significant: Asset Size (AssetClass) and Industry (Industry).

The partial derivatives of the equation are the *ceteris paribus* change in the log of the odds of a sanction for changes in the explanatory variables. A positive sign indicates an increase in the odds and a negative sign a decrease in the odds, for positive changes in the dependent variables.

In addition, another important measure is the odds, which are the exponents of the regression coefficients ($\exp^{(B)}$). Here, the coefficient sign is already reflected through the exponent of the coefficients, where a negative sign on coefficients will result in odds ratios of less than 1 but always greater than 0, while a positive sign on coefficients will result in odds ratios greater than 1.

Based on the model output presented in Table 5.21, the coefficient interpretations are as follows (with a rounding up to two decimal places and under *ceteris paribus* conditions):

OSTop *** = - 1.18: if share ownership by top shareholder increases by 1 unit, the log of the odds of receiving a sanction decreases by 1.18, or a 1 unit increase in share ownership by top shareholder affects the odds of a sanction by 0.30 times.

OSBlock = - 0.02: if number of block-holders increases by 1 unit, the log of the odds of receiving a sanction decreases by 0.02, or a 1 unit increase in number of block-holders affects the odds of a sanction by 0.98 times.

OSBoard5Percent = - 0.24: if board members have share ownership, the log of the odds of receiving a sanction decreases by 0.24, or share ownership by board members affects the odds of a sanction by 0.79 times.

BoCIndSize = - 0.07: if size of independent board member increases by 1 unit, the log of the odds of receiving a sanction decreases by 0.07, or a 1 unit increase in board independent size affects the odds of a sanction by 0.93 times.

BoCSizeClass ** ♦ = - 0.33: if size of board of commissioners increases by 1 unit, the log of the odds of receiving a sanction decreases by 0.33, or a 1 unit increase in board commissioners' size affects the odds of a sanction by 0.72 times.

BoCMeetFreq ** ♦ = 0.33: if board meeting frequency increases by 1 unit, the log of the odds of receiving a sanction increases by 0.33, or a 1 unit increase in board meeting frequency affects the odds of a sanction by 1.38 times.

ACExpSize = - 0.01: if size of audit committee expertise increases by 1 unit, the log of the odds of receiving a sanction decreases by 0.01, or a 1 unit increase in audit committee expertise size affects the odds of a sanction by 0.99 times.

ACMeetFreq *** = - 0.44: if audit committee meeting frequency increases by 1 unit, the log of the odds of receiving a sanction decreases by 0.44, or a 1 unit increase in audit committee meeting frequency affects the odds of a sanction by 0.65 times.

EAQual = - 0.20: if the external auditor is Big 4, the log of the odds of receiving a sanction decreases by 0.20, or choice of Big 4 auditor affects the odds of a sanction by 0.81 times.

Note: ***, **, ***** significant at 10%, 5% and 1% level, respectively
♦ the expected signs are contrary to the hypothesis (see Section 5.4.1 for further discussion)

For instance, consider the OSTop variable, which is significant at 1% level. The variable has a coefficient value of 1.18, with a negative sign. Holding other variables constant, if the share ownership by top shareholder increases by one unit percentage, the log of the odds of receiving a sanction decreases by 1.18. The corresponding odds ratio for this OSTop coefficient is 0.30 ($\exp^{(1.18)}$). Therefore, it could also be interpreted that a one-unit increase in share ownership by top shareholder affects the odds of a sanction by 0.30 times, holding other variables constant.

However, Gujarati (2011) argues that the 'log of the odds' or 'odds ratio' terms are not simple and are not very useful for practical interpretation. Moreover, the author contends that in the logistic regression model, the expected signs of the coefficients and their practical significance are more important than the interpretation of the logit model. The sign of coefficient refers to the direction of the relationship between the dependent and independent variables, while the practical significance refers to calculating the probability of the dependent variable from a given condition of independent variables, and assessing the predictive power of the developed model.

Based on these arguments, the remaining sections will analyse and discuss the model output with a specific focus on the significance of the variables, measuring probabilities and the predictive power of the model.

5.4.1. The Significance of Independent Variables

The following sections will discuss the relationship between the independent variables and the dependent variable resulting from the estimated model. The discussion and analysis will focus on the direction (coefficient signs) of the relationship between the independent and dependent variable, and will be organised under the factors influencing sanctions; that is, OS, BoC characteristics, AC characteristics and EA attributes.

5.4.1.1. Ownership Structure and the Incidence of Sanctions

With regard to the relationship between OS and the incidence of sanctions, the study employed three variables to represent OS: Top Shareholder (OSTop), Number of Block-holders (OSBlock) and Ownership by Board (OSBoard5Percent). The corresponding relationships are incorporated in the hypotheses H1, H2 and H3. However, the results show that only the top shareholder variable (OSTop) has a significant effect on the incidence of sanctions.

Share ownership by top shareholder (OSTop) was hypothesised to have a negative relationship with the incidence of sanctions (H1). The negative sign on the OSTop coefficient supports this hypothesis. This condition refers to the fact that the biggest shareholder, who holds a majority control over the corporation, will use their power to control management to perform their best to avoid any incidence of being sanctioned.

This finding supports the argument that large shareholders have an important role to play in monitoring and controlling management to achieve the highest possible performance (Shleifer & Vishny 1986). Further, in an environment of concentrated ownership like in Indonesia (World Bank & IMF 2010), the top shareholder controls the corporation and management with the intention to influence management to perform well to avoid sanctions.

The finding of a negative association between top share ownership and the incidence of sanctions also support the argument that family-controlled firms bring benefits. Family-controlled companies are prevalent among Indonesian-listed companies, and they have been argued to have lower monitoring costs, reduced agency costs and thus improved efficiency (Fama & Jensen 1983; Demsetz & Lehn 1985; McConaughy, Matthews & Fialko 2001).

With regard to the motives of holding large blocks of shares, this negative relationship between top shareholding and the incidence of sanctions is a reflection of the benefits of private and shared benefits of control. On the one hand, the controlling shareholders exercise private benefits of control by having access to private information regarding company compliance for behaviour that would at best avoid sanctions or at least minimise them. On the other hand, this private benefit of control is exercised to provide shared benefits of control to other shareholders from company performance, especially by maintaining the company’s reputation for adherence to regulation. It is expected that a good reputation will contribute positively to the market capitalisation of the company. This observation is a further indication that the top shareholders have multiple motives for holding large stakes, including private benefits and shared benefits (Holderness 2003).

Number of block-holders (OSBlock) and share ownership by board members (OSBoard5Percent) were found to be insignificant in this study. The block-holders, which are individual shareholders who own 5% or more of company shares, are expected to have significant stakes in the company and reflect various interests that compete to influence management. Therefore, it was envisaged that block-holders, with their various motives, would distract management effectiveness in running the corporation, thereby increasing the likelihood of sanctions. However, the study findings indicate that the existence of block-holders does not have a significant impact on the incidence of sanctions. This is possibly due to the controlling interests of the top shareholders protecting their own benefits at the expense of the smaller block-holders. Moreover, it is possible that some block-holders are actually informal agents of the top shareholder, further strengthening that shareholder's control. This explanation can be extended to provide an argument for the observed value and sign on the ownership by board variable. The top shareholder's power to influence the major decisions of the corporation overrides the rights and interests of the smaller shareholders. The effective control of the top shareholders, however, is further enhanced because of the many companies in which the majority of the board comprises family members of the top shareholders.

The finding that top shareholders has a significant impact on the relationship between corporate governance and the incidence of sanctions provides further evidence of ownership concentration in Indonesian-listed public companies. This phenomenon has been observed by Claessens, Djankov and Lang (2000) and the World Bank and IMF (2010), in general, and in many countries with weak legislative protection of shareholders in particular (La Porta, Lopez-de-Silanes & Shleifer 1999). Further, despite the evidence supporting dispersed OS among US corporations, Holderness (2009) challenges this finding and argues that US corporations' OS is concentrated, similar to in other countries.

There is also a reasonable chance that control by top shareholder is actually greater than reflected by the data for direct share ownership used in the present study. This study only measures CFR through direct ownership (percentage of shares owned), and thus ignores potential CR through pyramidal structure and deviation from the 'one share–one vote' principle, as advocated by Adams and Ferreira (2008).

The concentration of ownership in Indonesian-listed public companies, as shown in this study, also relates to the country's legal system, especially with regard to investor protection rights. La Porta et al. (1998) argue that concentration of ownership is negatively associated with investor protection, as owners and shareholders need to protect their interests through the accumulation of control power through share ownership in the corporation. Therefore, the concentration of ownership as shown by a significant proportion of top shareholders in this study reinforces the condition of weak investor protection in Indonesia (World Bank & IMF 2004, 2010). Although this study found that ownership concentration has a negative relationship with the incidence of sanctions, implying support for the effectiveness of corporate governance in preventing the incidence of sanctions, Scott (1999) argues that extensive corporate ownership concentration is usually associated with weak corporate governance mechanisms. Taking into account arguments about ownership concentration that relate to weak shareholder protection and corporate governance mechanisms, the current study concludes that, in general, ownership concentration has a negative association with corporate governance effectiveness.

5.4.1.2. Board of Commissioners Characteristics and the Incidence of Sanctions

The relationship between BoC characteristics and the incidence of sanctions is tested via hypotheses H4, H5 and H6. Three characteristics are used to analyse BoC: Board Independence (BoCIndSize), Board Size (BoCSizeClass) and Board Meeting (BoCMeetFreq). The results indicate that, of the three variables, only BoC size and meeting frequency (BoCSizeClass and BoCMeetFreq variables) have a relationship with the incidence of sanctions. The study sample does not provide support for a significant impact of the proportion of independent members within the board (BoCIndSize variable).

The board size (BoCSizeClass) variable was found to have an inverse relationship with the incidence of sanctions. This finding does not support hypothesis H5, where a positive relationship was hypothesised. The hypothesis was formulated based on the argument that larger board size beyond seven or eight members creates coordination and communication problems, whereas smaller board size produces improved board performance (Lipton & Lorsch 1992; Jensen 1993). Other evidence also supports smaller boards; for example, Persons (2006) argues that the likelihood of non-financial fraud decreases with smaller board size, and Yermack (1996) provides evidence for the greater effectiveness of smaller rather than larger board sizes.

However, there are also studies in favour of larger board sizes that support the present finding. Musteen, Datta and Kemmerer (2010) conclude that board size has a positive association with corporate reputation, while Rhee and Lee (2008) argue that board size is an important characteristic of firm quality, with investors considering board size an important clue. Investors believe that larger boards will have access to better knowledge and a wider network (Rhee & Lee 2008). These arguments are supported by the finding that board size has a negative relationship with the incidence of sanctions. Larger boards may have access to greater knowledge and more power to monitor management and therefore be more effective in monitoring and scrutinising management. This greater attention paid to management would have the effect of reducing the likelihood of sanctions.

BoC meeting frequency (BoCMeetFreq) was hypothesised to have a negative relationship with the incidence of sanctions (H6). However, the sample result shows that the BoCMeetFreq variable has a positive association with the incidence of sanctions. Theoretically, board meeting frequency should enhance monitoring of management. This test result could be the result of an increased number of board meetings following the detection of breaches, or impending breaches, of rules or regulations. Once detected, the board meets frequently to devise solutions and to monitor the implementation of corrective measures or to assess the performance of corrective measures. The breaches prevented will not be reported, resulting in the loss of valuable data and distorting the relationship. For example, a study in China by Chen et al. (2006) also found a positive relationship between frequency of board meetings and fraud. The authors argued that when a firm engaged or was about to engage in questionable activities, the board members held more meetings in which to debate the issue. This finding shows that BoC meeting frequency is ineffective in preventing the incidence of sanctions.

In relation to board independency, although Company Law requires Indonesian public companies to have at least one independent member on the BoC, the study results show that the variable BoCIndSize is not significantly related to the incidence of sanctions. This is likely to be due to the power of controlling shareholders impairing the ability of independent members to exercise their independence effectively. The observed relationship could be partly explained by the observation of the World Bank and IMF (2010) that members of the BoC have ongoing relationships with controlling shareholders, impairing the independence of these members.

The two-tier board system of Indonesia could be thought to provide better monitoring and more effective governance due to the separation of the supervisory and management functions

(Mantysaari 2005), and the majority of companies in the study sample had BoCs comprising more than two-thirds independent members, considerably exceeding the requirement of Indonesian law. However, the results show that BoC attributes have no significant impact on the incidence of sanctions. These findings confirm that in the Indonesian situation, the two-tier board system does not provide better corporate governance effectiveness compared to a one-tier board system. However, further work is required to identify the underlying reasons for this.

The above finding with respect to the two-tier board system concurs with the results of a study in China, where the two-tier board system has also been adopted. Xi (2006) stated that the supervisory board only provides minimal management monitoring, while Xiao, Dahya and Lin (2004) argued that supervisory board members in China could be described as friendly advisors or honoured guests. The Indonesian situation is somewhat similar to that of China. It is not uncommon for members of the BoC in Indonesia to have some sort of relationship, either familial or friendly, with the controlling shareholders.

With regard to board effectiveness on corporate governance, the OECD (2003, cited in Clarke 2007) classifies corporate boards in developing countries into two categories: *rubber stamp boards* and *family boards*. A *rubber stamp board* is one that has little or no role in governance; board meetings and decisions are simply formalities to meet certain regulatory requirements and play no role in the performance of the usual functions of a corporate board. The *family board*, as the name suggests, refers to boards whose members are chosen by controlling shareholders, and who at times could be close family members. This type of board is effective only to the extent of achieving the interests of the controlling shareholders.

From past studies and the results of the present study, it appears that whether the board is a one-tier or two-tier system does not have any significant effect on firm performance, although there is some impact on other factors.

Xi (2006) identified lack of crucial information, lack of expertise among board members and lack of legal support to take legal action by board members as the more significant factors contributing to board effectiveness. In the Indonesian situation, the strength of concentration of ownership and the relationship between board members and controlling shareholders considerably reduce the effectiveness of the BoC.

5.4.1.3. Audit Committee Characteristics and the Incidence of Sanctions

In the present study, the two explanatory variables included to capture the AC attributes in relation to the incidence of sanctions are AC Expertise (ACExpSize) and AC Meeting (ACMeetFreq), as stated in hypotheses H7 and H8. The results show that AC Meeting (ACMeetFreq) has a significance impact on the incidence of sanctions, while AC Expertise (ACExpSize) does not. AC meeting frequency has a negative relationship with the incidence of sanctions, affirming its effectiveness in improving performance. One of the important observations in the sample data is the delayed submission of financial reports resulting in sanctions. The finding for H8 confirms this.

It may be thought imperative that the AC be well versed in the concepts and practices accounting for optimal performance (Lee & Stone 1997). As such, an inverse relationship was hypothesised. However, the data does not provide sufficient support for this. Past studies have also failed to produce strong evidence to support a significant relationship between AC expertise and the incidence of sanctions. For instance, Mustafa and Youssef (2010) argue that the expertise of AC will only be effective if it is inherent to independent committee members. In the Indonesian regulatory framework, all AC members of public companies should be external to the entity, to preserve independence. The finding of the present study could thus be explained with the assertion of Mustafa and Youssef (2010). The independent nature of the AC members detaches them from the entity to the extent that they lack sufficient knowledge of the internal workings to perform their functions at the required level.

5.4.1.4. External Auditor Characteristics and the Incidence of Sanctions

This study uses EA quality (Big 4 or non-Big 4 auditor) as a benchmark for EA characteristics in relation to the incidence of sanctions. The finding suggests that EA quality does not have a significant impact on the incidence of sanctions, thus H9 is not supported.

This finding also implicitly reveals that EA is unsuccessful in contributing to the mitigation of conflicts between controlling and minority shareholders due to the strength of controlling shareholders. Moreover, in Indonesia, the appointment of the EA is determined by the GMS, at which controlling shareholders are able to influence voting.

The World Bank and IMF (2010) also argue that EAs' willingness to maximise their roles and contribute to corporate governance effectiveness may be affected by there being no cases of auditors that have been found guilty of sub-standard services in Indonesia.

5.4.1.5. Control Variables

Of the three control variables included in this study—Asset Size (AssetClass), Listing Age (AgeClass) and Industry (Industry)—the findings show that AssetClass and Industry have a significant impact on the incidence of sanctions at the 5% level, while AgeClass has a less significant impact at the 10% level.

Company asset class, measured on a scale of small, medium and large, has a positive association with the incidence of sanctions. The complexity of the operations of an entity is directly related to the level of underlying assets and hence increases the probability of being sanctioned.

The AgeClass variable refers to the length of time the entity has been listed on the stock exchange, and is measured on a three-point scale: young, mature and old. This AgeClass variable is found to have an inverse association with the incidence of sanctions. The age of an entity is a strong proxy for accumulated knowledge and experience. The application of this accumulated knowledge and experience seems to have a negative impact on the incidence of sanctions.

The variable of Industry is represented as a dichotomous variable specifying the type of industry as financial or non-financial. This industry classification is important, as different industry sectors will have different corporate governance structures and to some extent operate under different types of business culture (Dechow, Sloan & Sweeney 1996). The financial sector tends to exhibit higher levels of governance due to its nature and a higher level of regulation. For instance, the banking industry in Indonesia operates under an extra level of regulation compared to companies in other sectors. The results confirm that, due to the higher level of regulations, the probability of sanctions in the financial sector is low.

5.4.2. Measuring Probabilities and Predictive Power of the Model

As stated by Gujarati (2011), the practical implication of the logistic regression model is more important than its interpretation. The practical implication refers to the measurement of probabilities and assessing the predictive power of the model.

This section will present the predicted probability of sanctions for a random sample of companies with a range of attributes (see Table 5.27).

Table 5.27 Estimation of Probability of Sanction for a Select Set of Observations

Explanatory Variables[1]	Random Observations							
	1	2	3	4	5	6	7	8
OSTop	0.9914	0.668	0.5679	0.4451	0.5924	0.2084	0.3986	0.277
OSBlock	1	2	1	2	1	7	3	3
OSBoard 5Percent	0	0	0	0	0	0	0	0
BoCInd Size	2	2	2	2	1	2	1	2
BoCSize Class	1	2	2	2	1	1	2	1
BoCMeet Freq	2	1	3	2	2	2	2	2
ACExp Size	1	3	3	3	1	1	3	3
ACMeet Freq	2	2	3	3	2	2	1	1
EAQual	1	1	1	1	1	0	1	1
Asset Class	2	3	3	3	2	1	2	2
AgeClass	2	2	1	2	2	1	1	1
Industry	0	0	1	1	0	0	0	0
log odds	-1.3117	-1.1204	-1.6026	-2.0171	-0.7695	-0.5745	-0.2677	0.13435
Predicted Probabilities	0.2122	0.24593	0.16762	0.11742	0.3166	0.3602	0.43347	0.53354
Prediction (c=0.3) *	0	0	0	0	1	1	1	1

[1] the observation data has been measured according to explanatory variable measurements
* 1 = sanction; 0 = no sanction

Table 5.27 shows, for example, that the public listed company at observation number 1 has the following independent variables: top shareholder has 99.14% of shares; it has only one block-holder (the top shareholder only); there is no ownership of company shares by board members; size of independent members on BoC is level 2 (more than 1/3 and up to 2/3 of total members); size of BoC is level 1 (small = 0–4 members); BoC meeting frequency is level 2 (frequent = 4–12 meetings a year); AC members with expertise is level 1 (one-third = 0–1/3 of members); AC meeting frequency is level 2 (frequent = 4–12 meetings a year); the EA is a Big 4 firm; company asset size is level 2 (more than 1 trillion–10 trillion Rupiah); company age is level 2 (11–20 years of listing); and sector is non-financial.

Based on the set of corporate governance attributes for random example number 1, the probability of getting a sanction would be estimated based on the model at $p = 0.2122$. Using a cut-off value of 0.3, random sample number 1 is predicted as not getting a sanction ($p = 0.2122 < 0.3$).

The remainder of the observations (observation numbers 2–8) have similar variable interpretations according to the corresponding fields in the table. The table shows observations with their related corporate governance attributes and the corresponding probability of the occurrence of sanctions based on the 0.3 cut-off value.

The predictive power of the model has been partly discussed in Sections 5.3.3 and 5.3.4. Table 5.28 below summarises the predictive power of the model.

Table 5.28 Prediction Power of the Model

Model	Percentage Correct Predictions					
	Cut-off 0.5			Cut-off 0.3		
	Dependent Variable		Total	Dependent Variable		Total
	0	1		0	1	
Full Model *	96.00	11.27	71.04	62.47	60.56	61.91
Cross-validation Model **	93.95	19.75	73.65	53.49	64.20	56.42

* Full Model refers to the logistic regression equation model developed in this study
** Cross-validation Model refers to the logistic regression equation model generated from the in-sample data set, which is then used to compute the predicted probabilities using the out-of-sample data set. Lastly, the predicted probabilities and actual outcomes of the out-of-sample data are compared to obtain a classification table.

As shown in the table above, using a cut-off value of 0.5, the full model correctly predicts 71.04% of the time overall. However, the model performs poorly in predicting sanctions, for the estimated model as well as for the cross validation, at roughly 11% and 20%, respectively. When the cut-off is set at 0.3, however, the detailed performance seems to improve. A drop in the accuracy of the overall level of predictions is compensated for by a uniform predictive accuracy.

At the 0.3 cut-off value, the full model predicts 61.91% correctly: 62.47% for entities not being sanctioned, and 60.6% for entities being sanctioned. The cross validations confirm the accuracy of the initial model. Thus, the model and related logistic regression equation developed in this study produce accurate predictions when the cut-off rate is set at 0.3.

5.4.3. Attributes of Company That are Likely to Be Sanctioned

Given the model output and a set of corporate governance traits within the company, the probability of the incidence of sanctions could be determined for the whole sample data. This section will construct the attributes of companies with a high chance of sanction and those with a low chance of sanction (see Table 5.29). The objective is to determine the corporate governance attributes that may significantly affect the probability of being sanctioned. This will give a better understanding of which corporate governance attributes could contribute to higher or lower probabilities of being sanctioned.

Table 5.29 Company Attributes with Probability of Being Sanctioned

Variables	Probability of Being Sanctioned	
	Low	High
System Variables		
OSTop *	High ownership	Low ownership
OSBlock	More block-holders	Fewer block-holders
OSBoard5Percent	Board members own shares	No board member own shares
Policy Variables		
BoCIndSize	More independent members	Less independent members
BoCSizeClass *	Large board size	Small board size
BoCMeetFreq *	Less frequent meeting	More frequent meeting
ACExpSize	More committee expertise	Less committee expertise
ACMeetFreq *	More frequent meetings	Less frequent meetings
EAQual	Big 4 accounting firm	Non-Big 4 accounting firm

* significant at 5% level

As shown in Table 5.29, the company attributes in the study can be grouped as system variables and policy variables. The system variables refer to the variables that are beyond the control of the entity (that is, Top Shareholder, Number of Block-holders and Ownership of Board) and hence do not lend themselves to policy formulations to reduce the likelihood of sanctions. On the other hand, policy variables can be manipulated by companies to steer the entity away from the likelihood of sanctions. The policy variables in this study are Board Independency, Board Size, Board Meeting, AC Expertise, AC Meeting and EA Quality. These policy variables are also within the purview of the regulators, and therefore regulatory guidelines can be formulated around these variables.

Table 5.29 also shows the attributes of companies that have a low or high probability of being sanctioned. Companies with a low probability of being sanctioned are those with high ownership by top shareholders, more block-holders, ownership by board member, more independent board members, a larger board size, less frequent board meetings, more expertise among AC members, more frequent AC meetings, and audited by a Big 4 accounting firm. Companies with a high probability of being sanctioned are on the other end of the spectrum.

However, only some of these attributes are significant in terms of the incidence of sanctions. Therefore, based on the significant level, companies with attributes of high ownership by top shareholders, larger board size, less frequent board meetings and more frequent AC meetings have a low probability of being sanctioned. In contrast, companies with the opposite attributes have a high probability of being sanctioned.

The ability to profile companies in this way supports the necessity of actions, by either the regulator or the management/company and depending on whether the variables of concern are system or policy variables, to improve corporate governance effectiveness based on the corporate governance attributes discussed in this study.

5.5. Summary

This chapter presented the descriptive statistics of the data, outlined and performed model testing and discussed the results.

The descriptive statistics detailed the general conditions of Indonesian corporate governance based on the corporate governance attributes developed in this study. In Section 5.3, methods to test the robustness of the proposed model were examined, including correlation analysis, the *likelihood ratio* test and the expectation–prediction evaluation and cross-validation technique. Section 5.4 then discussed the results for all the variables in detail. This included comparing their relationship with the incidence of sanctions to the proposed hypotheses, evaluating the probability and predictive power of the developed model and identifying the company attributes that might lead to a low or high probability of being sanctioned. The analysis and discussion in this chapter answered the research objectives and research question.

The next chapter will summarise and conclude the study. It will also discuss the study limitations and make recommendations for future research and policy direction.

Chapter 6: Summary, Conclusions, and Recommendations

6.1. Summary

One of the major issues facing the corporate sector in Indonesia is the state of its corporate governance practice. A recent review by the World Bank and IMF (2010) noted that enforcement of corporate governance regulations is a major concern in Indonesia. The present study investigated the effectiveness of corporate governance implementation in relation to the incidence of sanctions.

Academic studies on corporate governance have mostly focused on the relationship between corporate governance and agency costs, firm performance, firm disclosure and firm value. Studies have also examined the effectiveness of corporate governance in preventing fraud or incidence of sanctions. These studies, however, have mostly focused on the issues relevant to developed economies. Only a handful of studies have been conducted in the Asian developing economies. Further, Indonesia has two other special features, which are a Civil law structure and a two-tier board structure. Many have argued for the need for in-depth analysis of corporate governance practices under a variety of governance structures and regulatory regimes (Vafeas & Theodorou 1998). The present study has thus been designed to fill an important gap in knowledge in the area of corporate governance.

The primary objective of corporate governance implementation is to curb fraudulent behaviour and business failures (Donker & Zahir 2008) and protect the interests of stakeholders (Mukweyi 2010). The aim of the study was firstly to conduct a detailed review of the current state of corporate governance, followed by estimating a model to predict the incidence of sanctions subject to a set of explanatory variables that are internal as well as external to corporate entities.

The data employed in the study comprised information on 1205 Indonesian-listed companies covering the period 2007–2010, and representing about 74% of the population. All the variables are obtained from secondary resources through company annual reports. The multinomial logistic regression model is employed to test the hypotheses, measure the relationships and predict the probability of sanctions.

6.2. Conclusions

An assessment of the outcome of the implementation of corporate governance regulations in Indonesia has been conducted by the World Bank and IMF (2004, 2010) through their ROSC reports. These reports assign Indonesia the status of having partially implemented corporate governance based on the OECD principles.

However, the most important issue of corporate governance implementation in Indonesia is its effectiveness. As enforcement was identified as a problem area by the World Bank and IMF, further assessment is needed to understand the degree to which performance has been improved, and the factors influencing the outcome of regulation implementation.

Another issue is the two-tier board system structure in Indonesia. Much of the literature is focused on the single board structure, and the performance of corporate governance under the two-tier board structure is not very well understood. Calls have been made for further studies to better understand the relationship between the attributes of the board, its members and company performance (Claessens 2006).

The literature on corporate governance provides evidence supporting a positive relationship between responsible corporate governance and company performance, but a granular analysis of the various results reveals that this relationship is inconclusive. Further work will contribute to clarify and provide further insight into some of the conflicting findings.

The purpose of the present study was three-fold. First, the study aimed to provide a detailed review of the current practices of Indonesian corporate governance. Secondly, the relationship between corporate governance and the incidence of sanctions was to be examined. Lastly, the study wanted to estimate a model to predict the probability of an entity receiving sanction subject to a set of corporate governance attributes.

This study measures corporate governance through four unobservable attributes: OS, BoC, AC and EA. These attributes are in turn measured by observable independent variables.

The independent variables and their associated factors are:

a. *Ownership Structure*: Top Shareholder (OSTop), Number of Block-holders (OSBlock) and Ownership by Board (OSBoard5Percent)

b. *Board of Commissioners:* Board Independency (BoCIndSize), Board Size (BocSizeClass) and Board Meeting (BocMeetFreq)
c. *Audit Committee:* Audit Committee Expertise (ACExpSize) and Audit Committee Meeting (ACMeetFreq)
d. *External Auditor:* External Auditor Quality (EAQual)

The sample included 74% of the population, providing a high degree of representativeness. The sample was selected for the period 2007–2010 from public listed companies in the Indonesian capital market. The data was obtained from secondary resources such as company annual reports and financial statements.

The following section provides a summary of the results of the study organised under the study objectives.

Objective 1: To provide a comprehensive review of the corporate governance attributes of the Indonesian capital market.

The present study confirms the concentration of ownership in Indonesian companies. The proportion of top shareholders who own more than 50% of company shares is high at 53.28% of the sample size. The average share ownership by top shareholders is 50.36%.

As the figure only reflects direct ownership, there is a reasonable chance that concentration of ownership by ultimate shareholders is even greater than shown in the company reports. The results also show the existence of multiple block-holders in the Indonesian OS system. Determining this allows the magnitude of dispersed ownership among shareholders (if any) to be identified, as block-holders have various interests that may influence agency conflicts.

However, the findings reveal that single block-holders (that is, the top shareholder only) are the largest proportion of the sample (28.38%) as compared to multiple block-holders. Further, a cross tabulation of data for these single block-holders reveals that most (86.84%) own more than 50% of shares. In other words, single block-holders (that is, the top shareholder) with more than 50% of shares are the largest proportion of the sample at 24.65% of the total sample. This confirms the high degree of ownership concentration in Indonesian-listed companies.

Share ownership by members of the BoC or BoD is not a significant issue in Indonesia. This attribute thus does not determine the incidence of sanctions. With regard to BoC attributes, for a majority of the companies in the sample, more than two-thirds of their BoC members are independent. This provides some credibility to the board, largely removes the possibility of conflicts of interest, and enhances the expected advantage of the separation of duties in the two-tier board system. The majority of Indonesian-listed companies have small BoCs, which is understandable given the two-tier board system. The boards of the majority of companies meet at least four times a year. These characteristics and practices of the BoC indicate acceptable corporate governance practices among Indonesian-listed companies.

The expertise of the members and meeting frequency are important attributes of ACs. The study found that for nearly half of the companies in the sample, the entire committee had some financial or accounting expertise. Further, nearly half of the companies met at least four times a year.

EAs play an important role as intermediaries in reducing information asymmetry between shareholders and management. The quality of this service thus determines the effectiveness of the outcome. Only a little over a third of the companies in the sample hired the services of one of the Big 4 audit firms. This implies that information asymmetry may be a serious issue for many Indonesian companies, assuming that the services provided by non-Big 4 auditors are not as effective as the services of Big 4 auditors.

Objective 2: To investigate the relationship between corporate governance and the incidence of sanctions or enforcement actions in the Indonesian capital market

The estimated logistic function is significant, and of the nine explanatory variables, Top Shareholder, BoC Size, BoC Meeting and AC Meeting are significant.

The estimates indicate that greater ownership by top shareholders diminishes the likelihood of breaches and, hence, the likelihood of a sanction. A possible explanation for this is that higher levels of ownership allow shareholders to exert greater control over management in avoiding breaches and reducing agency conflicts. However, given the concentration of ownership, agency conflict type II is likely to be a continuing issue that require a long-term solution.

BoC size was found to have a negative relationship with the likelihood of sanctions, whereas a positive relationship was hypothesised based on the literature. The contradictory finding of the study is further evidence that in Indonesia larger board size appears to be more effective in preventing breaches and subsequent sanctions. This is possibly due to the greater pool of knowledge, wider network and greater control exerted on the management by a larger board. These factors could result in more effective monitoring and scrutiny of management, thereby reducing the likelihood of sanctions.

BoC meeting frequency has a positive relationship with the incidence of sanctions, whereas a negative relationship was hypothesised. The observed positive relationship between meeting frequency and the incidence of sanctions could be a perverted one. It is possible that frequent board meetings are necessitated by identified breaches, which require deliberations to resolve. This aspect of corporate governance needs further study to arrive at a definitive conclusion.

AC meeting frequency has a negative relationship with the incidence of sanctions as hypothesised. This provides further confirmation of the vital role played by ACs in preventing breaches of regulations.

The findings, while failing to provide supporting evidence for all of the hypotheses, did provide greater insights into the state of corporate governance in Indonesia with respect to breaches and subsequent sanctions. The findings that contradict the current state of knowledge will require further investigation for validation.

Objective 3: To estimate a model to predict the probability of an entity receiving sanction subject to a set of attributes

A model was developed to predict the probability of sanctions subject to a number of explanatory variables. Tests of significance and the evaluation of the model's predictive accuracy indicate that the estimated model is robust. The estimated equation can be confidently applied for prediction purposes. This model can thus be employed by regulators as well.

Overall, the findings indicate that a main issue with corporate governance is ownership concentration. The implementation of corporate governance reforms has not resulted in any significant reduction in breaches and subsequent sanctions. Further, the two-tier board structure has not produced any favourable outcomes over and above the single-tier structure.

The argument that the two-tier board system, because of its supervisory board, outperforms the one-tier system in terms of independency (Mantysaari 2005) is not supported by the findings of the present study. About a third of the companies have received some form of sanction from the regulators.

The findings are in line with Clarke's argument (2007) that 'countries in the Asia Pacific region have established all the necessary mechanisms and institutions of corporate governance, however they were frequently nominal, almost ceremonial, with little active operation or meaning'. Further, Chen, Li and Shapiro (2011) assert that corporate governance implementations based on the OECD Principles have failed to solve major corporate governance problems. This is due to two dominant factors. First, OECD-prescribed corporate governance is only designed for mitigating agency conflict type I (conflict between shareholder and management), and not agency conflict type II (conflict between controlling shareholder and minority shareholders). Second, the BoC (supervisory board) tends to lack sufficient strength to be effective because they are mostly not independent, in that they are under the influence of the controlling shareholder.

6.3. Recommendations

This section presents some recommendations based on the findings of the study. Table 6.1 below summarises the hypotheses, conclusion, implication and policy direction of the present study.

Table 6.1 Summary of Hypotheses, Conclusion, Implication and Policy Direction

Finding	Policy Direction
Top shareholder has a controlling effect on governance, influencing company behaviour and its adherence to rules and regulations. The outcome depends on the willingness of the controlling shareholder to consider the interests of the minority shareholders and the other stakeholders of the company.	• Regulate the maximum shares that can be held by individual shareholders. • Improve the effectiveness of the monitoring mechanism of the controlling shareholders.
Effectiveness of the board improves with size and vice versa. Therefore, more competent and knowledgeable members are needed.	• Legislate for minimum levels of qualifications or competencies for board members.
Most audit committee members in Indonesian-listed companies are already equipped with necessary knowledge. However, they do not significantly contribute to effective prevention of being sanctioned.	• Review the competency levels of audit committee members and determine the limitations of current levels of competency. • Legislate for continuous professional development of audit committee members.

The findings show that concentration of ownership by top shareholders is prevalent in the Indonesian capital market. Top shareholders have a controlling effect on governance, influencing company behaviour and its adherence to rules and regulations. The findings of the study imply that greater concentration of ownership could contribute to the reduction of the incidence of sanctions. However, this also has a detrimental effect on minority shareholders' interests (agency conflict type II).

Based on the above situation, to maximise benefits to all stakeholder and minimise conflicts, the controlling shareholder should be willing to consider the interests of minority shareholders and the other stakeholders of the company. Monitoring controlling shareholder behaviour is crucial to minimising possible actions of expropriation against minority (public) shareholders. To some extent, a limitation on maximum share ownership by individual shareholders could prevent a controlling shareholder from becoming 'too powerful'. In addition, the regulator and other stakeholders should improve the effectiveness of the monitoring mechanism in regulating the behaviour of controlling shareholders.

Empirical evidence shows that larger board size has a positive effect on reducing the likelihood of sanctions. The implication of this is that larger board size will equip the board with better competencies and knowledge to maximise its monitoring effectiveness. Regulators should require boards of listed companies to set a minimum standard of competency and qualifications for its members.

With regard to the AC characteristics, only AC meeting frequency was found to be significant in explaining the incidence of sanctions. Although most AC members in Indonesian-listed companies are already equipped with necessary knowledge, it appears that they are not effective in preventing sanctions. Continuous review of the competency levels of AC members, and requiring them to participate in continuous professional development, could be an approach to resolve this.

6.4. Study Limitations

The study design adopted was well suited to achieve the stated objectives, guided by current knowledge and constrained by the availability of useable data. However, it did suffer from certain limitations. These limitations did not affect the outcomes in general, but overcoming them would help to attain a deeper understanding of the link between the attributes of governance and the incidence of sanctions of listed companies.

One limitation, though not a serious one, is the reliance on data disclosed in annual reports. Following Indonesia's adoption of a mandatory reporting regime for corporate governance implementation, it has been argued that this approach could lead to a 'box ticking' mentality that could result in inaccurate reporting of data due to regulatory pressure (Arcot, Bruno & Faure-Grimaud 2010). One approach that could mitigate this limitation is to supplement secondary data with information from interviews. It is, however, doubtful whether the respondents would provide any data that is not affected by the pressure to conform.

Regardless, future research should consider observing corporate governance practices through a combination of primary and secondary sources. A variety of suggestions have been offered in the literature, such as evaluating corporate governance effectiveness through appraising boardroom performance (Conger, Finegold & Lawler 1998) and direct observation of boardroom practice (Leblanc & Gillies 2005). These corrective measures may not be practical under all circumstances.

The data collected did not provide sufficient detail on the level of sanctions; for instance, there were no observations of sanctions for levels higher than 2. This is mainly due to the relatively short period for which reporting has been mandatory. A detailed analysis of the impact of corporate governance practices on the level of sanction would produce greater insight into the topic. This, however, is subject to sufficient number of sanctions to produce adequate variation.

Another useful area for investigation is the impact of the two-tier board system. Indonesia offers a unique environment for this study given it is one of very few countries to have adopted this approach, especially among emerging markets. The results of such an investigation would provide useful knowledge, especially to appraise the value of such a structure, given the extra costs involved.

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Appendices

Appendix A Summary of Literature Review

No.	Authors (Year)	Description	Method	Findings/Conclusion
1.	Jensen & Meckling (1976)	Provides theoretical background for a new ownership structure theory. This theory is developed from agency theory, property rights theory and finance theory	Literature review and theory development	Agency costs are real costs similar to other costs, and could be minimised through law and contracts between parties. Corporations as one economic organisation form have been tested by the market and have survived against other forms of economic organisation
2.	Fama (1980)	Explains the separation of security ownership and control as an efficient form of economic organisation	Theory development	The separation of security ownership and control can be explained as an efficient form of economic organisation within the 'set of contracts' perspective (a nexus of contract)
3.	DeAngelo (1981b)	Argues that auditor quality is not independent of auditor size	Presents arguments relating to auditor size and independency	Audit quality is not independent of audit firm size, even when auditors initially possess identical capabilities. In particular, when incumbent auditors earn client-specific quasi-rents, auditors with a greater number of clients have 'more to lose' by failing to report a discovered breach in a particular client's records. This collateral aspect increases the audit quality supplied by larger audit firms
4.	Fama & Jensen (1983)	Reviews separation of 'ownership' and 'control' in an organisation and related agency problems	Conceptual theory development	The organisation was viewed as a nexus of contracts. Hence, there are survival values to support separation of ownership and control.

No.	Authors (Year)	Description	Method	Findings/Conclusion
5.	Hart (1995)	Provides a theoretical framework for corporate governance debates in which corporate governance is relevant, and explains its implication for public companies	Theory development	Corporate governance issues arise when contracts are incomplete and agency problems exist. A market economy sometimes can achieve efficient corporate governance by itself
6.	Beasley (1996)	Investigates the inclusion of outsiders in Board of Director's composition to reduce the likelihood of financial statement fraud	Employs logit regression analysis between fraud and no-fraud firms in the US for the period 1980–1991. Fraud and no-fraud sample were sourced from AAERs SEC and WSJ Index (Crime: White Collar Crime)	A higher proportion of outsiders on the Board of Directors reduces the likelihood of financial statement fraud
7.	Franks & Mayer (1996)	Examines the disciplining function and poor performance prior bids of hostile takeovers in the UK	Examines hostile takeover activities in 1985 and 1986 in the UK using data collected from AMDATA, a database for takeover	There is little evidence that hostile takeovers are motivated by poor performance prior to bids. Hence, the view that hostile takeovers perform a disciplinary role is rejected
8.	Davis, Schoorman & Donaldson (1997)	Introduces a new theory of governance, stewardship theory, based on sociological and psychological approaches	Theoryl development	An alternative model of managerial motivation and behaviour is stewardship theory, where managers choose to behave as stewards or agents. Their motives are based on growth, achievement and self-actualisation by accomplishing organisational rather than personal agendas

No.	Authors (Year)	Description	Method	Findings/Conclusion
9.	Kabir, Cantrijn & Jeunink (1997)	Examines the relationship between firms' takeover defences and their ownership structure and stock returns in the Netherlands	Uses logistic regression analysis with an event methodology study. The sample is drawn from the Amsterdam Stock Exchange and represents more than 90% of Dutch stock market capitalisation	Firms with lower ownership concentration (more diffuse ownership) are more likely to adopt more takeover defence mechanisms. Further, there is no evidence to support that institutional stockholders provide better monitoring than other block-holders
10.	Shleifer & Vishny (1997)	Analyses the importance of investor legal protection and ownership concentration in corporate governance around the world	Literature review	Investor legal protection and ownership concentration are essential elements for good corporate governance, helping shareholders receive return on their investments
11.	Xu & Wang (1997)	Investigates whether ownership structure has an effect on firm performance in China	Using pooled data from Chinese-listed companies for three years, applies regressions of performance variables on concentration ownership ratio	In China, ownership structure has significant effects on firm performance. There is a positive and significant effect between ownership concentration and firm profitability
12.	Conger, Finegold & Lawler (1998)	Appraises Board of Directors' performance and effectiveness	Discuss an effective way to appraise Board of Directors' performance	There is no easy and effective way to appraise a Board of Directors' performance. However, Board of Directors effectiveness will enhance the relationship between the Board and management

No.	Authors (Year)	Description	Method	Findings/Conclusion
13.	La Porta et al. (1998)	Examines legal rules covering protection of corporate shareholders and creditors, the origin of these rules and the quality of enforcement in 49 countries	Literature review and observation	Laws concerning investors' protection and enforcement differ greatly around the world, with Common law countries having better protection and enforcement compared to Civil law countries. In response to poor investor protection, a mechanism was developed using ownership concentration
14.	La Porta, Lopez-de-Silanes & Shleifer (1999)	Examines ownership structures of large corporations in 27 wealthy economies to identify the ultimate controlling shareholders of these firms	Review of a new database of ownership structures of companies from 27 countries. Large firm sample consists of 540 firms	Most of the firms in 27 wealthy economies are controlled by families or the State, except in economies with very good shareholder protection. The controlling shareholders typically have control rights exceeding their cash flow rights, through the use of pyramids structure and participation within management. These condition are quite contrast to Berle and Mean's image of ownership of modern corporation, which is widely held beliefs
15.	Weimer & Pape (1999)	Introduces a taxonomy of systems of corporate governance as a remedy for lack of coherence in the international context	Theory development and observation	Propose four types of systems of corporate governance based on eight international characteristics: Anglo-Saxon systems, Germanic systems, Latin systems and Japanese systems
16.	Claessens, Djankov & Lang (2000)	Examines the separation of ownership and control in East Asian countries	Examines the separation of ownership and control for 2980 corporations in nine East Asian countries using data collected from Worldscope, related handbooks and the stock exchange	The separation of ownership and control is pronounced among family-controlled firms and small firms. At least two-thirds of firms are controlled through single shareholders, not widely spread as is currently believed. Significant corporate wealth in East Asia is controlled by and concentrated in only a few families

No.	Authors (Year)	Description	Method	Findings/Conclusion
17.	Jenkinson & Ljungqvist (2001)	Shows that the German corporate governance system for corporate control is more active that has been previously suggested	Case study of 17 cases of building hostile stakes, over an 8-year period in Germany	In Germany, hostile tender offers are relatively few. A more important and common means of gaining control is through the building of hostile stakes
18.	DeZoort et al. (2002)	Identifies factors that contribute to audit committee effectiveness	Literature review on factors behind audit committee effectiveness	The determinants of audit committee effectiveness are audit committee composition, authority, resources and diligence
19.	Faccio & Lang (2002)	Analyses the ultimate ownership and control of corporations in 13 Western European countries	Analyses ultimate ownership and control of 5232 corporations in 13 Western European countries using data collected from Worldscope and the stock exchange	In Western European countries, firms are typically family-controlled (44.29%) and widely held (36.93%)
20.	La Porta et al. (2002)	Evaluates the influence of investor protection and ownership by the controlling shareholder on corporate valuation	Uses origin of a country's laws and index of specific legal rules as an indicator of shareholder protection. Tobin's q used for corporate valuation. Model tested using a sample of 539 large firms from 27 wealthy economies	Firms will have higher company valuation in countries with better protection of minority shareholders and in firms with higher cash flow ownership by controlling shareholders

No.	Authors (Year)	Description	Method	Findings/Conclusion
21.	Tabalujan (2002)	Explores family capitalism in Indonesian-listed companies, with a focus on how family relationships and values can influence corporate governance	Discussion of corporate governance of family-controlled listed companies in Indonesia	Family relationships and values are potentially significant in Indonesian corporate governance. Family capitalism is a third paradigm of corporate governance, supplementing the managerial capitalist paradigm of the Anglo-American systems, and the alliance capitalist paradigm prevailing in Japan and Germany
22.	Denis & McConnell (2003)	Surveys two generations of corporate governance systems: the individual governance mechanism as the first generation, and international corporate governance across countries as the second generation	The survey was conducted based on a literature review	The first generation of corporate governance reveals differences in governance systems across countries, which can be explained by the countries' legal systems, in particular investor legal protection
23.	Gompers, Ishii & Metrick (2003)	Uses 24 corporate governance provisions to construct a 'Governance Index (G-Index)' to proxy level of shareholder rights and how this affects equity prices	Construction of Governance Index for 1500 large firms during the 1990s in the US	Firms with stronger shareholder rights had higher value, higher profits, higher sales growth, lower capital expenditure and fewer corporate acquisitions
24.	Hermalin & Weisbach (2003)	Provides insights into Board of Directors from perspective of economic literature	Literature review	The Board of Directors is an integral part of an organisation, whether corporate or non-corporate. This institutional arrangement arises endogenously in response to inherent agency problems
25.	Alijoyo et al. (2004)	Reviews Indonesian corporate governance implementation	Report	Indonesia has elaborated corporate governance principles into law and regulations. However, two areas for improvement remain: shareholders' roles and Board effectiveness (in the two-tier Board system, this means both the Board of Commissioners and the Board of Directors)

No.	Authors (Year)	Description	Method	Findings/Conclusion
26.	Spira & Bender (2004)	Reviews the establishment of Board subcommittees and their effectiveness as part of the corporate governance mechanism	Interview of Board subcommittee members, especially members of the audit and remuneration subcommittee	There are significant differences in the orientation and operation of the audit and remuneration committee, and the roles of non-executive directors
27.	Uzun, Szewczyk, & Varma (2004)	Examines the characteristics of the Board of Directors and the occurrence of corporate fraud in the US	Review pairwise comparisons between fraud and no-fraud firms, and use logit regression analyses. Sample obtained from US WSJ Index (Crime: White Collar Crime) from 1978–2001.	Board of Directors' composition and its oversight committee structures are significantly related to corporate fraud. More independent members on the Board of Directors and the audit and compensation committees reduces the likelihood of corporate fraud
28.	Persons (2005)	Examines the relationship between the likelihood of financial statement fraud and corporate governance requirements	Logit regression analysis to test fraud firms and no-fraud firms. Financial statement fraud sample obtained from AAERs US SEC for the period 1999–2003	Audit committee member independency (not sitting on another company's directorship) and length of tenure reduces likelihood of financial statement fraud being committed
29.	Bourke (2006)	Investigates the relationship between fraudulent financial reporting and corporate governance attributes	Logit regression analysis to test fraud and no-fraud sample from AAERs US SEC database for the period 2004–2006	Percentage of independent directors, existence of nominating committee and employing a Big 6 auditor are negatively related to the incidence of fraud

No.	Authors (Year)	Description	Method	Findings/Conclusion
30.	Brown & Caylor (2006)	Uses 51 provisions to construct a ‘Gov-Score’ to reflect both internal and external governance	Formulates a Gov-Score for 1868 firms as of 1 February 2003	Conclude that only seven provisions underlying Gov-Score are fully related to firm value
31.	Chen et al. (2006)	Examines whether ownership structure and board characteristics have an effect on financial fraud in China	Bivariate probit model to test relationship. Sample from CSRC (China regulator) enforcement actions for the period 1999–2003	Board characteristics have a greater influence in reducing the likelihood of fraud as compared to ownership structure characteristics. The characteristics likely to reduce fraud are higher proportion of outside directors and greater board meeting frequency
32.	Persons (2006)	Identifies corporate governance characteristics that can potentially reduce the likelihood of non-financial reporting fraud	Logit regression analysis to test non-financial fraud firms. Sample obtained from US WSJ Index for the period 1992–2000	The likelihood of non-financial fraud is lower if the BoD has a greater proportion of outsiders, different people holding the positions of chair and CEO, and smaller BoD size
33.	Abdelsalam & El-Masry (2008)	Examines the influence of board independence and ownership structure on timeliness of financial reporting in Irish-listed companies	Uses a multivariate model with a sample of 44 Irish-listed companies.	Timeliness of reporting is positively associated with Board of Directors’ independency and CEO ownership

No.	Authors (Year)	Description	Method	Findings/Conclusion
34.	Bourne (2008)	Analyses the inclusion of a corporate governance index in the financial ratios formula as a joint predictor for fraudulent financial reporting	Logistic regression to test relationship between inclusion of Brown and Caylor's Governance Score Index and the incidence of fraud using sample of 2000 firms, obtained from CRSP for the period 2001–2005	The inclusion of Brown and Caylor's Governance Score Index and a financial ratio creates a useful model for predicting fraudulent financial reporting
35.	Da Silva Rosa, Filippetto & Tarca (2008)	Investigates whether companies subject to an Australian Securities and Investment Commission (ASIC) action have poorer corporate governance than other companies	Uses a matched sample of 240 companies (including 120 ASX-listed companies subject to ASIC actions) between 1 July 1998 and 31 December 2004	Companies subject to ASIC actions are less likely to comply with the Australian stock exchange (ASX) best practice governance recommendations, with the main area of difference being the separation of the roles of CEO and board chair
36.	Donker & Zahir (2008)	Investigates the most popular corporate governance rating systems and their usefulness to shareholders and the public	Critical review	There is a weak relationship between corporate governance rating score and corporate performance

No.	Authors (Year)	Description	Method	Findings/Conclusion
37.	Ezat & El-Masry (2008)	Examines firm characteristics and corporate governance variables to investigate the influence on the timeliness of corporate internet reporting in Egyptian-listed companies	Employs a multiple regression model with a sample of 37 companies on the Cairo and Alexandria Stock Exchange (CASE) at the end of 2006	Companies with a high proportion of independent directors, a large board size and a large number of free float shares in the market will disclose information in a more timely manner
38.	Mangena & Chamisa (2008)	Reviews the association between corporate governance structures and incidences of listing suspension in South Africa	Uses a matched-pairs analysis of suspended and non-suspended firms and employs a conditional logistic model to test the relationship. Sample is 81 suspended firms from the Johannesburg Stock Exchange (JSE) for the period 1999–2005	The likelihood of suspension is higher in firms with a smaller proportion of non-executive directors, without an audit committee and with greater block-share ownership and higher gearing. No association is detected for board size, role duality, directors' share ownership, auditor quality or return on assets
39.	Bebchuk, Cohen & Ferrell (2009)	Uses six additional provisions to create an entrenchment index (E Index) to reflect corporate governance practice	Constructs an Entrenchment Index for the 1990s in the US	Six entrenching provisions are negatively correlated with firm valuation

No.	Authors (Year)	Description	Method	Findings/Conclusion
40.	Holderness (2009)	Challenges the common view of US public firms' ownership concentration. Current thinking holds that US firms are generally diffusely owned, and more so than comparable firms elsewhere	Compares hand-collected data on large-percentage stock ownership for representative sample of Compustat- and CRSP-listed firms with hand-collected data from 22 European and East Asian firms	Most US public firms have large-percentage shareholders, and the ownership concentration of US firms is similar to the ownership concentration of corporations elsewhere
41.	Jeanjean & Stolowy (2009)	Investigates the determinants of Boards' financial expertise in French-listed companies	Construct a measure of financial expertise based on educational and career background data for 943 individuals occupying 1140 posts and explore the determinants of average per-firm financial expertise using a Tobit analysis	Financial expertise is negatively associated with board type (two-tier versus one-tier) and growth opportunities. However, board independence, ownership concentration and institutional ownership are positively associated with financial expertise

No.	Authors (Year)	Description	Method	Findings/Conclusion
42.	Jia et al. (2009)	Examines the role of a supervisory board in an enforcement action situation in China	Logit model to test the relationship between supervisory board characteristics and incidence of enforcement action. Sample drawn from CSMAR, SINOFIN and WIND (China database) for all years since 2000. The sample was found to include 362 firms that had committed fraud and 327 firms that had not committed fraud	The supervisory board plays an active role when firms are under enforcement actions, with severe enforcement actions found in firms with larger board size and more frequent board meeting
43.	Lo, Wong & Firth (2010)	Investigates corporate governance structure and the management of opportunistic behaviour (transfer pricing manipulation) in China	Employs regression model from 266 firms from Shanghai Stock Exchange in 2004	Higher proportion of independent directors, different people holding the chair and CEO positions, and financial expertise within the audit committee will decrease the likelihood of transfer pricing manipulation
44.	Nuryanah & Islam (2011)	Examines the relationship between internal corporate governance mechanisms and firm performance in Indonesia	Employ multiple regression analyses to test the relationship. Data is obtained from JSX listed companies for 138 observations within three years (2002–2004).	Internal corporate governance mechanisms, except for size of Board, audit committee and management ownership, are significant in explaining company performance in Indonesia

No.	Authors (Year)	Description	Method	Findings/Conclusion
45.	Warren et al. (2011)	Investigates the role of the compensation committee and CEO remuneration to minimise corporate fraud	Uses a causal modelling approach to estimate CEO incentives and corporate fraud (illegal earnings statement)	CEOs' stock-option compensation is a motivator to commit corporate earnings fraud, while cash salaries and bonuses are only indirectly related to earnings fraud through those stock options
46.	Ghafran & O'Sullivan (2012)	Reviews recent literature on various aspects of audit committee governance for audit committee effectiveness	Synthesises and identifies specific characteristics of various components of audit committee effectiveness	Investors value the presence of audit committees and react positively when members are appointed with relevant expertise. Certain audit committee characteristics, specifically independence, expertise and frequency of meetings, lead to more effective audit committee performance